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THE FLAT TAX: THE POTENTIAL FOR ECONOMIC GROWTH

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED FOURTH CONGRESS

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THE FLAT TAX: THE POTENTIAL FOR ECONOMIC GROWTH

Wednesday, May 17, 1995

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D. C.

The Committee met at 10:05 a.m. in Room 106 of the Dirksen Senate Office Building, the Honorable Connie Mack, Chairman of the Committee, presiding.

Present: Senators Mack, Craig and Bennett; Representatives Quinn and Mfume.

Staff Present: Paul Merski, Jeff Styles, Lee Price, Chad Stone, Roni M. Singleton, Larry Hunter, Michael Gaines, Shelly Hymes, Missy Shorey, Brian Wesbury, Bill Spriggs, and Robert Mottice.

OPENING STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Senator Mack. The hearing will come to order. I believe we will go ahead and proceed. I've got an opening statement but why don't you go ahead and make your statement, Congressman.

OPENING STATEMENT OF REPRESENTATIVE JACK QUINN

Representative Quinn. Thank you, Senator.

I begin by saying that I appreciate your work and that of Congressman Saxton in calling a hearing today. We are equally pleased to have Congressman Dick Armey and Senator Specter here to join us this morning.

I would like to recognize Dr. Rabushka of the Hoover Institute and others this morning who have talked to us many times on our side of the aisle about the importance of taxes and how it affects not only this country but certainly our districts.

Back in Buffalo, New York, which I represent, our citizens are very concerned about the amount of money that they send to Washington, D.C., and how our Representatives use and spend that money.

I look forward to the testimony of all the witnesses this morning. We appreciate your leadership in calling the hearing.

Senator Mack. I have a short opening statement. Then we will get right to our two colleagues.

We are here today to examine one of our nation's most critical issues, one that will impact the prosperity of every American. That issue is tax reform and its effect on economic growth.

While numerous tax reform ideas have been suggested in recent months, our focus today will be on the economic growth potential of a flat tax system pioneered by Professors Robert Hall and Alvin Rabushka of Stanford University. There is a large and growing consensus among economists, lawmakers and grassroots Americans that our current income tax system has become a tremendous obstacle to economic growth and our standard of living.

After eight decades of misuse by lawmakers, lobbyists and special interests, our tax system is unfair, costly and punishes work, savings and investment. Simply stated, our onerous income tax system is unfit to carry us into the 21st Century and prevents us from enjoying a better future for ourselves, our children and our grandchildren.

Since its 1913 enactment, our income tax system has fallen prey to a multitude of unintended purposes, including income redistribution, social engineering and government micro management of our savings, investing and spending policies. As a result, our tax system treats individuals unfairly, extracts tremendous compliance costs and hinders the full productive potential of our economy. Sadly, our current income tax system hinders every American's potential for a higher standard of living.

Therefore, we need to fundamentally rethink the manner in which income is taxed in order to construct a system that is equitable, efficient and can support economic growth. In order to achieve genuine tax reform, the blinders must be taken off, special interests must give way to the overriding national concerns, the politically motivated rich-versus-poor class warfare must stop and the defenders of the status quo must make way for positive change.

Tax tinkering or simply reshuffling the existing tax burden is not genuine tax reform. We must create a new tax structure that allows everyone to benefit from economic growth while at the same time preventing the anti-growth tax system we have now from ever re-emerging.

The flat tax encompasses this new thinking and fundamental change needed to create a fair, simple and pro-growth tax system. While the flat tax would help correct the inequities and complexity in our current tax system, I believe the most important reason to undertake any tax reform is to improve our standard of living. If tax reform fosters just five-tenths of a percent in GDP growth, the typical American family after five years would have incomes more than $3,000 higher than they would be under the current tax law.

The most important benefit that the flat tax could offer all Americans is unparalleled economic growth. The flat tax is such a fundamental change from the way government does business today that there are no economic models which can fully calculate its impact on economic growth. Nobody, not Congressional Budget Office (CBO), not Office of Management and Budget (OMB) not the Treasury Department nor the Joint Committee on Taxation has predicted the dynamic potential of the flat tax.

As Chairman of the Joint Economic Committee, I have called this hearing to examine the effects of the flat tax on individual behavior, corporate behavior and the economy in general. In short, the information we need to make an informed decision.

No doubt, the typical static income distribution and revenue models used to trumpet the so-called tax winners and losers will be used in an attempt to scare us into preserving the status quo. However, these models cannot encompass the real essence of the flat tax, its potential to make everyone better off through economic growth and increased incomes across all classes.

Today, the graduated income tax system garners an increasing share of people's hard work and success. It is no wonder Americans feel that they are working longer and harder with nothing to show for it because they are. For 82 years, the Tax Code has gone to accommodate the demands of special interest groups. It is now time for a tax system that addresses the economic concerns of the typical taxpaying individual and family.

Now, I look forward to hearing the testimony from our impressive lineup of expert witnesses joining us here today. This morning I am particularly pleased to welcome Senator Specter and Congressman Armey. We look forward to your testimony.

Senator Specter, why don't you begin.

[The prepared statement of Senator Mack appears in the Submissions for the Record.]

PANEL I

STATEMENT OF THE HONORABLE ARLEN SPECTER SENATOR FROM PENNSYLVANIA

Senator Specter. Thank you very much, Mr. Chairman.

At the outset, I compliment the Joint Economic Committee for scheduling these hearings because I believe that the flat tax has such merit that once it is sufficiently understood by the American people, and I might say also by the Congress, that there will be a clamor for its enactment.

I have long been intrigued by the flat tax and started to give it very serious consideration last summer. One of the first things I did was to call our distinguished colleague, the now Majority Leader of the House, who wasn't when I talked to him, late summer, early fall, about the flat tax because he was the only Member of the Congress to introduce legislation on the subject.

Now I am delighted to be in his company both at the witness table and having introduced the only flat tax legislation in the Senate, Senate Bill 488.

It was a fair-sized step to introduce the legislation because of the concerns I had on many, many aspects until I had undertaken sufficient study to be confident about it, conferring with the authors of the plan, Professor Hall and Professor Rabushka, Professor Rabushka being here today.

By taxing all income at the source of business, it is possible to have the flat tax as recommended by Professors Hall and Rabushka, who set the figure at 19 percent, which is tax neutral. As I will comment in a minute or two, my proposal is slightly different, at the 20 percent rate, because I allow two deductions. Those deductions are particularly important to middle-income taxpayers. These two deductions for interest on borrowing up to $100,000 on the cost of a home and charitable contributions up to $2,500 because I believe that those two deductions are so deeply ingrained into the pattern of Americans that it is not practical to pass a flat tax, a tax that is flat without those two deductions.

I think that it is going to be very, very hard to pass it in any event. Yesterday a group of realtors met with me and notwithstanding some approval at the level of the national officers, one of whom I met at a Republican fundraising gathering last night, it is not going to be easy, when you lower the deduction on interest from a million dollars, which it currently is, to $100,000, and when you limit the charitable contributions. So I believe as a concession to practicality, those two deductions have to be included.

When I studied the plan, and it is almost too good to be true -- but I believe it is true -- to see the projections of the lowering of the interest rate by 2 percent and to see the gross national product (GNP) increased by two trillion dollars over seven years -- that is an extraordinary accomplishment.

What Congress needs to do is to spend as much time or at least considerable time on the growth factor in the economy as we are spending now on reducing governmental spending. There is a consensus and a commitment to have a balanced budget by the year 2002 but that is only one side of the economic coin. The other side of the economic coin is to have growth and expansion -- and the flat tax is extraordinarily pro-growth.

We have seen the problems with the fall of the dollar in recent years, recent months, recent weeks, recent days really. The answer to the stability of the dollar is to stop the imbalance of trade and to stop the Federal deficit and to stop the tremendous borrowing from foreign sources, which are practically taking over our country, and that would be done by savings which would be promoted by the flat tax, which imposes no tax on capital gains, interest and dividends.

The flat tax is fairly involved. I was discussing just this morning with Professor Rabushka the questions that I have had raised and now have a better answer for, as to why it is not regressive to have people pay no tax on interest. It is understandable on capital gains and on dividends because they have already been taxed, say, in the corporate structure. But Professor Rabushka points out that no tax is necessary on interest. Interest has already been taxed because there is no deduction for interest payments by businesses.

So if you have a dollar in a corporation, it has not had a deduction for interest. That then makes that an 80-cent dollar. So that when that interest is received by a person, then there should be no tax on it. That doesn't come through too clearly. It will take a little more explanation but I will reserve that for the open house town meeting because I know the panel understood it even before I started to explain it.

The best part is the simplicity and this is what I start with in my own open house town meetings. A saving of 5,400,000,000 hours. I will be interested to see how Professor Rabushka quantifies that with precision. That is why I always grab and hold up the postcard, which is the tax return.

So with my distinguished colleague, Majority Leader Armey here, I am going to abbreviate these remarks and I would ask that my full statement be made a part of the record.

Thank you very much, Mr. Chairman and Congressman Quinn.

[The prepared statement of Senator Specter appears in the Submissions for the Record.]

Senator Mack. Majority Leader Armey.

STATEMENT OF THE HONORABLE RICHARD K. ARMEY, MAJORITY LEADER, U.S. HOUSE OF REPRESENTATIVES, REPRESENTATIVE FROM TEXAS

Representative Armey. Thank you, Mr. Chairman, for calling this hearing and it is a special delight for me to appear before this Committee.

I spent a couple of the most enjoyable years of my service in Congress on this very same Committee so I know your work I think fairly well, and I cherish the Committee for the work it does.

I should say that when I first began working on a flat tax proposal over a year ago I wondered how would America respond to a new generation of flat tax.

When I came to Congress in 1985, there was a great debate about the flat tax. It was very much in vogue in the great debate and the 1986 tax bill brought all of that debate, it seemed, to an end. So I was curious, how would America respond.

I have to tell you, Mr. Chairman, I have been amazed at the extent to which the flat tax has been embraced by the American people. It is a very live proposition in the minds and expectations of the American taxpayer and the American voter because it does so many things. I would like to focus my attention today before this Committee on what the flat tax does relative to the question of economic growth and I will begin by asserting that it is the inherent desire, goal and objective, the natural volition of any community, to raise its standard of living.

If you wanted to talk about a driving compulsion of a community of people with respect to economics, there are other compulsions as well that are compelling. But with respect to economics, it is to raise your standard of living, to do better material, to make the most efficient allocation of resources toward the highest production of those goods which you desire the most.

I would argue that this is an incentive so inherent in the community that it is not an incentive that government policy can give a community. Government policy can accommodate to that desire by complying with what I would posture to be the necessary first rule of good government, do no harm. I believe that the current Tax Code of the United States comprehensively impedes our nation from achieving the highest standards of living possible.

It does this by inspiring or requiring, in fact, that very implementation -- anywhere from $400 to $450 billion a year in sheer deadweight loss, just for compliance with the Tax Code. That is $450 million worth of the resources, resourcefulness and energy of the American working men and women, just to do nothing other than fill out paperwork to comply with this tax code.

There is no person among these that can't take those talents and skills to something that is more productive toward the end of achieving a higher standard of living than waiting on the government.

Senator Mack. What did you say the amount was again?

Representative Armey. Estimates are from $400 to $450 billion. That, incidentally, is also translated rather colorfully into the fact that we Americans spend more labor hours each year complying with the tax code than what we spend producing all of the cars, trucks and vans produced in this nation. And I daresay that they would be far better used producing more cars, trucks and vans than complying with government-mandated red tape.

Beyond the deadweight loss is the sheer inefficient use of precious resources. The current Tax Code provides disincentives to savings and investment and if I might go back to Adam Smith and 1776 when he wrote about the way a nation achieves economic growth. His exact language was, "Abstinence and Capital Formation." The two go hand-in-hand -- savings and capital formation.

It is also very important for us to realize that in the interest of getting more out of less through a more efficient use of our resources, that thing we call productivity, you must need apply the newest science and engineering discoveries of a culture in the production process through what we call the innovation of technology.

Technology is innovated through the acquisition of capital equipment and I will give you a quick example. I was standing on a plant floor in my District a few years ago with a machinist. This machinist was a skilled workman, had no college education, had no formal training beyond that which he had learned on the job. And he was standing as I talked to him, lovingly polishing his new machine.

And he said, "Congressman, I would like to show you this piece of equipment. This thing cost over a million dollars. It has something called numerical control, which is a computerized process by which I am able to machine, with greater degrees of precision than ever before, making my customers more happy and with a higher level of output than I ever achieved before. And when they brought it in here, I was a little puzzled because I had never sat before anything that looked like computerization in my life but I did the natural thing. I turned to the fellow that was installing it and said, how do you make this thing go?"

Now, this was science and engineering knowledge that was far beyond anything this gentleman had ever had an opportunity to study or even see before, applied in the machine. The machine gets put on the floor and the labor adjusted to the requirements of the technology. And he was that day machining with greater precision and output than he had ever done before.

He then pointed out, he says, "Because we can do so much more and so much better with this machine, my productivity has gone up and my wages have gone up." So he says, "I am the first beneficiary of this machine and, you know Congressman, I could have worked all my life and never had enough money to buy a machine like this."

Implicitly he was saying, I sure am thankful for all those people who saved and made it possible. That is the way capital formation increases productivity and causes economic growth which translates into higher wages which ends up letting a machinist on the floor with a machine enjoy a greater share of our mutual shared goal of a higher standard of living.

In fact, when you take a look at the current Tax Code and look at the disincentives for savings and investment, obviously there is a tax burden that applies directly to savings. Savings, incidentally, must originate with the household. The fundamentals of income and production in America is all income is generated from production and all income is taken by individuals and those individuals can either save or consume their income or pay taxes, and all taxes are paid by people and paid out of current income flows.

Now, you can levy taxes any way you want to try to hide that fact, but, in the final analysis, all taxes are paid by people, by current income flows, so we bias against the saver because you diminish the reward to the saver by taxing savings, interest earnings, at the household level.

You have a double taxation in the Tax Code as we know it today on virtually all income that is generated on the provision of capital to the production process.

Now, what do we do with the flat tax to encourage growth? Essentially, we say we remove the existing disincentives to economic progress that you find in the current Tax Code. It is true that all interest is taxed but interest paid is not taxed directly at its source. Business does not write down interest as a business expense and the homeowner does not pay taxes on interest accrued but they do not deduct interest from their expense, hence for the purpose of being uniform and holistic in the treatment of interest, we find it necessary to drop the home mortgage deduction. But let me just say in a larger sense with respect to that, with the flat tax, high-growth world, we create a world in which the home interest deduction need not be necessary nor precious to the homeowner because their chances of participating in economic growth enables them to a far more greater opportunity to buy a home.

The impact of this should produce mortgage rate reductions and we think the homeowner will be better off. Indeed, I have said to my real estate friends that if I made my living out of real estate transactions, I would be an advocate of the high-growth flat tax world as opposed to the relatively stagnant world that our current Tax Code promotes.

So with the ending of double taxation on earnings generated from the provision of capital, I think we provide an enormous incentive to provide more capital. With the elimination of taxation on savings at its source in the household, we provide an incentive for more household savings. Indeed, the flat tax, as I envisage it, gives every household in America what amounts to an open-ended IRA for any purpose they deem fit.

A final part of the Code as I propose it that I would mention is we encourage business to expense capital. At the time you buy that new machine and you install it, you write it off. This, I think, is particularly important, given the inter-temporal dynamics of the

American economy and indeed the world economy. The great growth areas are in the high technology areas like communications, computerization and so forth, where the march of science and engineering is at such a rapid pace that you need a rapidity of capital turnover to keep up with scientific and engineering progress. In those high-growth potential areas of our economy, I think it is especially helpful to be able to expense capital at the time you install it because science and engineering knowledge may make that obsolete within just a few years and therefore you can much more quickly and more easily engage in the turnover necessary to keep your ability competitive, not only within this nation but with respect to other nations.

I would argue then that the growth potential of the American economy with our creative and entrepreneurial abilities and our natural volition to achieve higher standards of living is unimpeded by a flat tax. There is a great old country song from "Annie Get Your Gun" saying doing what comes naturally. It is my conviction that when the American people are allowed, unimpeded by their government, to do what comes naturally, they will do their best and a tax code that has neutrality with respect to savings, investment and consumption and within those categories is a Tax Code that gives more freedom to the American people to do their best for themselves and their families. Such a tax code unleashes that freedom and that ingenuity will result in a greater standard of living.

Our prediction is that, by the year 2002, if we enact a flat tax, we could see the average American family enjoying real income gains of as much as $7,600 a year as we unleash that potential to innovate greater capital-based productivity through higher investment.

I, as I said, Mr. Chairman, hope that you will put my more formal remarks in the record and I am available, of course, for questions.

[The prepared statement of Representative Armey appears in the Submissions for the Record.]

Senator Mack. We will see that the prepared statements of both you and Senator Specter are included in the record.

Let me ask both of you if you are in a position to remain for a few minutes for some questions, or do you have --

Representative Armey. I believe I am.

Senator Specter. Other things are pressing but I would be delighted to stay.

Senator Mack. I think I will start with Congressman Armey and just ask you to take your opening statement and identify for us two or three of the major items, the changes that you think will take place, that in fact will enhance growth in this country as a result of the flat tax.

Representative Armey. The flat tax as I envision it first of all, you will have more household savings. There will be a greater volition to supply the capital markets from the household because, of course, they receive the rewards without penalty. You will have a greater volition on the business side for investment to take place, one, because the owners of the business are not subjected to a double taxation.

Right now, you invest -- say you buy a stock or a bond and say you buy stock in a business. The business has earnings, those earnings are subjected to a business tax. Then when the earnings are subsequently distributed, they are taxed again to the individual as dividends. We eliminate the taxation of dividends at the individual level and therefore drop the double taxation of earnings from business enterprise. As a consequence, you have a greater volition to invest in business enterprise. That, of course, is the source of the revenues, which results in capital formation.

You must have capital investment if you are going to have technological innovation. It is just an absolute imperative. You cannot innovate technology unless you bring it on line in the form of some capital equipment and then, of course, the volition, the ability to expense the capital again, gives a greater volition to make more time-sensitive, more technologically growth-sensitive responses in your capital investment.

Those would be the three big things that I would cite that would be the growth components.

Senator Mack. Let me toss this out to both of you. It is a question that any of us who have been involved in this discussion on the flat tax have heard and I think it is going to be a question that is going to be posed at almost every juncture. That is, the income distribution tables, there will be efforts to show winners and losers under a flat tax and I would be interested, from both of you, how you respond to that.

In essence, if you are going to reduce marginal tax rates, doesn't that almost by definition imply that there are going to be some winners and losers?

Either one of you can respond.

Senator Specter. The statistics which I have seen show that there are all winners in individual taxation because there will be less individual taxes paid of $245 billion because that will be taxed at the source and business is in favor of it because there is decreased compliance costs of $165 billion a year and the business interests also approve because of the elimination of double taxation.

Congressman Armey and I have slightly different exemption rates. I follow Hall/Rabushka on having an exemption for a family of four so that no tax will be paid up to $25,500. The most recent statistics available for 1992 on IRS show that about 54 percent of the American people have adjusted-gross income of $25,000. Now that is a little different than a gross income, but I think that is an indicator that about half of the American people will pay no tax at all under the flat tax proposal because the exemption will cover all of their income up to $25,500.

I would like to make available for the record, in addition to my statement, a schedule which shows the percentage of tax paid all the way up to those in excess of a million dollars and no longer will there be tax shelters or gimmicks to preclude any tax at all since those over a million dollars in income will be paying an effective tax rate of 19.3 percent on their income. So there are winners everywhere up and down the line.

Representative Armey. Let me just say first of all there has been no definitive study of the distribution. The Treasury did something but what they scored was not my proposal.

The one thing, probably the most prominent statement we have is a statement that the President made in a press conference a couple of weeks ago where he said the studies he had seen indicated that all people over $100,000 or $200,000 will be winners and all people under $200,000 will be losers. That statement -- which has probably been the most prominent statement -- I can tell you with sheer conviction, is 100 percent wrong, particularly because the President chose to use "all" in both cases.

I have a great many testimonial letters from people who have said that they did this. We just went through tax season, we had enough currency and public domain of the flat tax card that we had thousands of people that laid down their taxes after four weeks of work on them and finally signed the bottom line, crossed their fingers, hoped that it was right and cheered for no audit.

They then picked up my card and 15 minutes later discovered they were better off if they had done it in 15 minutes my way.

The one thing that we do know is virtually everybody gets a rate reduction and of course the reduction in the marginal rate is what provides the incentive for more work to couple with all that new capital equipment we will have out there.

The one thing you also have to keep in mind is that as you bring down the rates and simplify the code, you also broaden the base. We have at least $400 billion, perhaps more, of income that escapes the Tax Code altogether today while we are double taxing some. I am always amazed by people who are obsessed with fairness who think it is fair to have $400 billion worth of income that doesn't even get in the tax base while you are double taxing somebody else.

But when you do that base-broadening you find out a greater share of the relative tax burden is borne by business-generated income as opposed to wages-generated income and we think the distribution charts when they are finally worked out are going to demonstrate that there is a sufficient progressivity in a flat tax to satisfy anybody's idea of fairness. But I must argue that the overwhelming testimony that I get from the thousands and thousands of people that I have heard from on the flat tax is, fairness is treating everybody the same. I think, although there may be an academic love affair still going on with the old notion of tax progressivity, I think that, quite frankly, is a sentiment that is hardly shared by real people in America that treats everybody exactly the same.

Senator Specter. Mr. Chairman, if I might supplement the answer, my answer, just for a sentence or two?

Businesses would pay $245 billion more in taxes. Individuals would pay $245 billion less. That is why it is a benefit to individuals in all brackets. Businesses, which includes all individuals engaged in business activity, and not just corporations, would have an offset for that increase in taxation by having a reduction in compliance costs of $165 billion and the expanded economy of more than $2 trillion in seven years. The reduced debt financing and expanded equity financing also offsets their increase in tax payments so that they wind up preferring it to the current system.

I do think that we will need some corroboration of these figures from Professors Hall and Rabushka to satisfy everybody, but I think the Majority Leader of the House has put his finger right on it in dispelling the notion that President Clinton was correct with his broad brush that all the people in the upper brackets are winners and all the people in the lower brackets are losers because that conclusively is incorrect.

Representative Armey. I just might add when the President made that statement I just looked at the heavens and said, Lord, thank you for delivering my enemy unto my feet.

Senator Mack. Congressman Quinn.

Representative Quinn. Thank you.

Mr. Chairman, we are indeed fortunate to have Members from both sides here in the Congress who are able to put forth the plan.

A couple of observations, first of all: Mr. Armey, you mentioned this is an idea that is alive and I couldn't agree with you more. When I get back to my district, people approach me about a lot of the issues we are dealing with here, particularly since we finished our Contract, as you know, recently.

This whole notion that something can be fair for everybody, something can be simplified, is alive and I think both of you are right on the mark with your efforts for this and we appreciate it.

Senator, in your prepared remarks you talked a little bit about limited deductions in terms of the mortgage situation and charitable giving. The people whom I talked to almost believe the political necessity to include those. I tend to agree with you. I think that people over the years have sort of come to believe that they own those kinds of deductions and you have talked about those a little bit.

Dick, I am wondering, in your plan have you talked about those kinds of things as Senator Specter has? Do we open the flood gates if we allow for two deductions, or is it three, is it four, is it five? So I guess my question is to Mr. Armey: I am sort of on the side of Senator Specter on this one, with people that I talk to back in my District, so what is your sense, Dick, in terms of where that is going to go?

Representative Armey. We studied on this very early and one of the things I must tell you, going back to my '84 and '85 experience, the flat tax was alive once before and it died.

One of the things I studied on why did it not fly like an eagle before, I believe once you begin to put in exceptions, you have put in certain principles and write a code that conforms to those principles and once you start with the exceptions, every exception becomes a first best reason for the next exception. Pretty soon what you have done is to open the flood gates.

So as I have started my effort on the flat tax, I have basically said, stay flat or die. Start making compromises and you will lose the flat tax.

You know, it is not my natural tendency to be stubborn. I am by nature an accommodating person. But the fact is, I think you have got to protect the flat tax from accommodations. Again, I would go back -- I have people who come to me very honestly concerned about the home mortgage deduction, not the least of whom is my brother-in-law.

And I begin by saying, you must first envision a world where the home interest deduction is neither necessary nor precious to you. That is a high-growth, flat tax world. But we believe with the economic growth, you will get a lower interest rate because of the treatment of savings and a greater opportunity. Just as I thought, that volition to improve your well-being comes before the government. Our volition to own a home is not wedded to our treatment in the Tax Code. We want to own a home.

I might say this, though. The great American dream is not owning your own home. The great American dream is getting your kids out of it.

(Laughter.)

Representative Armey. You get your kids out of your own home and you have a dynamic, growing economy that is creating job opportunities where these youngsters can complete their education, complete their training, know they are going to a great job, have a home of their own, start giving you grandchildren and stay out of your house.

(Laughter.)

Representative Armey. I think those dynamics are going to make everybody better off.

Representative Quinn. Dick, I could say thanks for the response. I want to get to the Senator and give him an opportunity. There is a gentleman here in the audience, Jack Quinn, Sr., who would agree with the idea to get you out of the house.

(Laughter.)

Representative Quinn. Senator, can you comment on what you mentioned in your prepared remarks, please?

Senator Specter. The deductions which I permit in Senate Bill 488 are very, very minimal. They have been costed by the Joint Economic Committee at $35 billion for deducting home mortgage interest up to $100,000. Please note the limit on that. It is really for middle income America and barely that. And the $2,500 deduction for charitable contributions costs $13 billion a year and those are very, very minimal.

I believe that is a line which can be drawn and can be adhered to. When you start talking about the other deductions on medical expense, it is so complicated to figure that out now that you really don't get anywhere with most Americans. You talk about deduction for state and local taxes, it is difficult. Tough questions in New York City when I present this plan, but that is to a limited number of people. Also there, most people see the advantage in having the expanded economy and the lower interest rates and understand that overall there will be offsets to that extent.

When you deal with the vast body of Americans who are very used to the deduction for home interest, I think that there will be an immediate negative reaction if there is no deduction. Many mortgages these days are over $100,000 so there is already a concession in that amount.

We are a church- and synagogue-going country and it may be that the charitable contributions will be given without a deduction but there is a sense that it is necessary. And $2,500 does not accommodate the wealthy who get enormous deductions and use it as a shelter by means of giving art, which has an inflated value at least over the purchase price.

So I think this is baseline minimum which will enable us to withstand the onslaught which we are going to have from special interest groups. This is going to be very, very tough legislation to pass and I think this minimal concession is just a practical necessity.

Representative Quinn. Thank you very much, Mr. Chairman.

Senator Mack. Senator Craig.

OPENING STATEMENT OF SENATOR LARRY CRAIG

Senator Craig. Mr. Chairman, first of all, let me thank you for using this forum to begin to build a broader base of understanding of the flat tax. I think that is tremendously important. It is also a privilege to have Professor Armey with us today and Senator Specter.

I must say at the outset that Senator Shelby and I will be introducing the professor's legislation in the near future. We are doing some joint tax scoring at the moment and a few technical details and we hope to get that introduced within the next couple of weeks so there will be a full counterpart measure here in the Senate.

Senator Specter. Why not just co-sponsor my legislation, Senator Craig?

Senator Craig. I am getting to that, Senator, because I respect you greatly for introducing it.

Representative Armey. If you did that, could I accuse him of kidnaping or something like that?

Senator Specter. Senator Craig is no kid, Congressman Armey.

Senator Craig. But one of the reasons I chose, and I think Senator Shelby chose not to become co-spcnsors is because of the stay-flat-or-die articulation that the professor just went through and I think that is very important.

While we are in the business of helping educate the American people and while I know why you did what you did to avoid some of the confusion and/or the reaction, I went through a simple test this year with my wife after we had spent several hundreds of dollars paying for the necessary preparation of our tax forms. The evening they arrived in the packet from our accountant at our home, we sat down and took out Mr. Rabushka's and Mr. Hall's book and used the simplicity of the book and we applied it that evening within 30 minutes to our not very complicated tax requirements. We did it just that way.

Now, we had been afforded the deductions that all of us are. We happen to own two homes, both with mortgages, one in Idaho and one here, so we may pay a little more interest than does the average family across America who probably only has one home and a few other things, and some charitable deductions.

I will tell you that if every American did what we did in that 30-minute period, this room would be full, there would be crowds on the steps of the Capitol demanding that this Congress produce a tax bill and therefore a tax law very similar to what Dick Armey has put together.

The reason is very simple. While we pay a substantial amount in taxes, we would have paid approximately $2,250 less in taxes using this application over what we are currently paying, with all the socially-engineered deductions that this Congress has so wisely put before the American people over the last 50 years.

That is why I want a clear or a clean proposal to start with, Senator. But let me say at the same time, in a much less critical fashion, I am glad that you have pushed the issue. More of us need to do it. The debate needs to go on across this country. We clearly need to resurrect and make alive once again this concept.

Let me also say one other thing because I have no questions. I think you have handled the issues, both of you, very adequately.

When I came to Congress 14 years ago to begin to get a flavor of the game playing that goes on here with staff and those who serve on the "tax writing" committees, and I use the words "game playing" dramatically underlined, I began to recognize that very few people do, in fact, create social engineering in this country through tax law. That experience came in 1982 in a great debate that resulted in allowing certain types of companies business deductions for use of ownership and use of helicopters while other companies were not allowed the use or the deduction for the ownership and use of helicopters.

I began to investigate why this Congress would so wisely decide a business deduction on one hand for a certain type of company and a non-business deduction but an expense on the other hand for a similar aircraft. The answer was simply there was a Member of the Taxation Committee in the House who did not like logging companies using helicopters for logging because he was an environmentalist and didn't like logging in the first instance and he was skillful enough to disallow them a similar deduction that another company used to transport people with helicopters. So the difference was simply the mind set of the individual, the great wisdom of the congressman who had a prejudice and used the tax law of our country for engineering and for speaking to that prejudice.

It was at that point that I became a flat taxer and I will stay that because it is the best tax policy for our country and for everyone in our country and we simply have to get away from the tradition and therefore the attitude that we have to have all of these deductions because it somehow makes the place better for us when, in fact, it doesn't; we just think it does.

My guess is when you ask people about their charitable deductions, and I asked that of my wife and myself after we played the 30-minute Rabushka game, and I found out that the incentive was no different. We would have saved more money this year in taxes and we would have still contributed every bit as much to charities as we are able to contribute. In other words, the deduction was no longer the incentive, the incentive was in the heart.

Thank you.

Senator Mack. Thank you, Senator.

Congressman Mfume.

OPENING STATEMENT OF REPRESENTATIVE KWEISI MFUME

Representative Mfume. Thank you, Mr. Chairman.

Let me just say also that I think this hearing has a great deal of importance and significance, regardless of where we may be on this issue, simply because the issue is all around us. I don't think that we can walk away from it or pretend that there is not some interest there. I think it would also be disingenuous to pretend that there is not a great deal of concern by people who rightfully, or wrongfully, see this as something that may be threatening or jeopardizing to them, depending on where they are on the economic ladder and depending also on what their perspectives are, quite frankly. So I do welcome the opportunity and certainly welcome both of the distinguished panelists.

This is a novel idea, to say the least, but that doesn't mean that novel ideas have never worked in the past. My dear friend, Mr. Armey, who, thanked the Lord once this year for delivering his enemies to his feet should be careful. The Lord continues to deliver things. Let's see what he has up his sleeve next.

I thank you for the testimony. I am sorry I got here a bit late but I have been trying to brush up on some of your perspectives on this. I called it novel before because it is really switching the tax base from income to consumption and replacing the multiple progressive tax rate with a single rate. You know, the jury is still out on some of this, but CRS and the Treasury, as you both know, view this essentially as a value-added tax (or the equivalent of a value-added tax). But there are some other questions I want to go to, and some points that I would like to raise, and maybe get you to comment additionally.

It seems to me that there are several questions that have to be asked. Number one, will this new flat tax, if it were to be enacted, lead to improved economic performance (as we know it) in this country. And, if it does, what proof do we have to suggest that, and is that proof empirical?

The second question is, is it fair? Fair is such a subjective term that, depending again on where you are in the economic scheme of things, it raises concerns for a lot of people.

The other issue is, is it simple? Obviously, at first blush, everyone will say that it is simple, but I think if we look at the corporate community or business requirements, that may not in fact be the case.

I see Mr. Kemp who is here who first said something to me about this years ago when we were Members of the House together. I hope I also get a chance, Jack, at some point in time to hear from you.

I want to quote from the text of Mr. Hall and Mr. Rabushka. We tend to look at their work as the beginning and the end, or certainly the bible on this discussion, and I want to ask both Senator Specter and the House Leader if they would comment on an assertion that is in the book that I found very interesting, and I think goes to the heart of one of those three questions.

It seems that Hall and Rabushka noted that their flat tax, and this is a quote, would be a tremendous boon to the economic elite and that they honestly delivered what they admitted was "some bad news." They suggest, and I think I am accurate in my accounting of this, that "it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people."

Now, I don't know exactly what they had in mind. If you read that, and I assume we will get a chance to talk about it later, it suggests that somebody is going to get hit, and it goes back to the second question, is it fair as we know fairness to be?

If both of you could talk for a moment about that or respond to that assertion by the authors, I would appreciate it.

Senator Specter. Mr. Chairman, if I may Congressman, respond first, I just ask the Majority Leader if he would mind if I do that because I am going to have to ask to be excused for a few moments because I have a commitment at 11 a.m.

When you talk about fairness, I think that is a fundamental question. Perhaps the fundamental question. As I had outlined earlier, taxation will be $245 billion less on individuals because there is $245 billion more on businesses as Hall and Rabushka have outlined in the tax picture. With an exemption of $25,500 for a family of four, that would take in about 50 percent of the American taxpayers who would pay no tax at all and the shelters and the loopholes are eliminated, so that there will be tax on everyone, period.

There appears to be an exception for that for individuals who have tax only from interest but even there, because interest is not deductible, the company which would be paying out interest on their money would be paying out 80-cent dollars because they would not have been permitted to deduct interest themselves. So even as to interest payments, the recipient would be getting instead of a dollar, only 80 cents because that is all the business would have to pay, so that there is an effective tax rate on the very wealthy of 19.3 percent and today many millionaires are able to shelter all their taxes and pay none at all.

This is a hard concept to really work through but I believe that to be the fact. It is a matter of analysis and study and understanding.

On the question of productivity, I believe the evidence is very, very strong and apparent on the surface that if the company is able to have a full deduction in the year of purchase of equipment, no more depreciation schedules, it is going to be a tremendous incentive for business expansion and the calculations are to reduce the interest rate by 2 percent and to increase the gross national product (GNP) by two trillion dollars over seven years, which is a 14 percent increase from the seven trillion dollar GNP we have at the present time. By not taxing capital gains, we will be in the same situation as other countries -- Japan and Germany -- where we now borrow great sums of money from. By taxing all income at the source and eliminating the tax on dividends and capital gains as well as interest, we will be promoting savings, where Americans are grossly deficient at the present time.

By not being in a situation where we have to borrow from foreign sources, that is going to tremendously strengthen the American dollar. So as the plan is projected I think that it has tremendous merit and what we really need to do is to provide more jobs and better paying jobs for all Americans at all levels.

We spend an insufficient amount of time, it seems to me, on growth and productivity contrasted with our tremendous study of balancing the budget, which is very important. But the other side of the coin, as I had said earlier, is a pro-growth plan.

So, Congressman Mfume, I think that there is a lot to recommend this program. What we really need to do is to think it through and to answer those two questions which you posed, which are the basic questions: Fairness and productivity which benefit all Americans.

Representative Mfume. Senator, you can see the concern on behalf of a lot of people when you get Hall and Rabushka saying that the average person, essentially, is going to take a hit, and when you have the Treasury Department in its analysis showing that the tax burden on middle- and lower-income families would rise under this tax, and Citizens for Tax Justice calculate that a family earning about $40,000 is going to have to pay $150 more a month.

When those studies, which are not connected, become part of the dialogue and the discussion in the public domain on this, it is clear why a lot of people have apprehensions, and why a lot of people argue also that proponents of the tax ought to be able to talk about how, in fact, those things won't occur.

My time has expired.

Representative Armey. Mr. Chairman, I would like to respond because there are a few things --

I will say first of all how anybody in the world could say that there is any similarity between the flat tax and the value-added tax other than the fact that they may have similar bases and that by adjusting the rates you could get the same tax take outcome is beyond me. So let me just say the flat tax is the antithesis of the value-added tax. I love the flat tax as much as I abhor the value-added tax. The value-added tax, in my estimation, is the most insidious tax devised by man, so I must, please make the point, the flat tax is in no way similar to the value-added tax.

Representative Mfume. That may be the argument because wages are a major component of value-added.

Representative Armey. Wages are going to be a major component of any tax, first of all.

Let me say the fundamental difference between the value-added tax and the flat tax is the flat tax is honest. I have tried to be as clear as I can be. But the quote you have from the Hall, Rabushka book is from their '83 book where they looked at the distributional impact of what was proposed in that book. The exact quote you took about getting more from one place or less from another was about share of total tax burden, which we know.

One of the most remarkable things that history has proven to us time and time again is whenever you lower the marginal rates, the share of total tax burden from the rich goes up because, frankly, more people get more richer. It works out nicely that way.

I think professors Hall and Rabushka will be up as soon as I have the good grace to get out of here and they will be able to give you testimony about the revelations in their latest book.

If I may, I know I have overstayed your time on the clock and probably my welcome. And, Congressman Mfume, I know you've recognized me, a man whose passion -- but I have an equal share of passion for value-added tax and flat tax, and I'm sorry if my emotions spilled out a bit when I saw somebody dashing to make a comparison between the two.

One final thing I would say. Neither the Citizens for Tax Justice nor the Treasury Department scored the Armey proposal. There were a lot of problems with both those scorings. Citizens for Tax Justice have remained unwilling to acknowledge any of the errors they made, although the Treasury Department has acknowledged some of their errors. But their distributional studies, I don't think, are anywhere near. There will have to be more work done. We are not insensitive to the question of fair.

But if I can close with this one story about who speaks for fairness, multiple rates are always arbitrary. We have one rate for everybody and it is the lowest rate we can get to and have anything that smacks as deficit neutrality. But the night after the President made his amazing revelation about how all people gain above $200,000 and all people lose under $200,000, I was walking into a hotel -- I'll tell the story quickly -- in Dallas, Texas. The fellow who parks the cars, a fellow who doesn't, obviously, make a great deal of money, came over to me and said, you can park your car over there next to that Lincoln because I love the flat tax. I thought that was very gracious. And he says, I'll tell you why I love the flat tax. He says, it treats everybody the same; there's one rate for everybody and we don't have to listen to all this class warfare baloney.

That man spoke more for America than I think the President did the night before. And the thing I found most ironic about that wonderful event was this was identifiably, precisely the person the President thought he was speaking for.

America believes fairness is when everybody is treated the same and I think America deserves to give itself a pat on the back for that belief.

Representative Mfume. Thank you, Mr. Chairman.

Senator Mack. Thank you very much, Congressman Armey. Secretary Kemp.

Mr. Kemp. Thank you, Mr. Chairman. May I leave my coat off?

Senator Mack. Whichever you are most comfortable?

Mr. Kemp. I am most comfortable with my coat off.

Senator Mack. I will make a short introduction and then we will look forward to your statement.

Jack Kemp is the co-director of Empower America, a public policy organization started in January 1993 to advance social and economic policies which empower people, not government, and expand entrepreneurial capitalism around the world. Jack Kemp is perhaps our nation's greatest promoter of economic growth through sound tax policies. His groundbreaking efforts on tax reform more than a decade ago in Congress paved the way for major tax reforms in 1981 and 1986. These reforms were giant steps in improving the Tax Code and they fostered economic growth that boosted the standard of living for all income groups.

Jack's knowledge of both tax policy and economic growth keep him in high demand by those interested in improving our tax system and enhancing economic growth. No doubt his role on the Tax Reform Commission will again provide policymakers and the nation with the guidance needed to achieve pro-growth tax policy changes.

Jack, we welcome you this morning and look forward to your testimony.

PANEL II

STATEMENT OF THE HONORABLE JACK KEMP, CO-DIRECTOR OF EMPOWER AMERICA AND FORMER SECRETARY OF HOUSING AND URBAN DEVELOPMENT

Mr. Kemp. Thank you, Mr. Chairman. I sit here with a great degree of envy because this is the Committee upon whose panel I had wished to serve for so long. I envy the men and women of the Committee and appreciate the opportunity, Mr. Chairman, to be with you and my good friends Bob Bennett, Larry Craig and Kweisi Mfume, for whom I have always had a high degree of respect, regard and friendship.

So this is a fascinating issue and I want to congratulate you, Mr. Chairman, for bringing it to the attention of Congress and the American people. I wish it were on C-SPAN, not for myself, but for the type of questions that will be asked, the type of debate it will engender, the edification that will be enhanced so that the American people can, in this post Cold War era, begin to recognize and understand how important it is to have a tax system consistent with fairness, the formation of capital, opening of opportunities, removal of barriers to mobility and fluidity, and equality of opportunity, all things that I think are bipartisan in nature and for which you, Mr. Chairman, are so well known in your home state of Florida, and for which I have tried to fight in my lifetime in politics and public policy.

I approach this with a great deal of humility. A Chinese philosopher said one time, there is a great deal of wisdom in the world but unfortunately it was all divided up among people.

There is a great deal of wisdom on this issue. It is divided up. There is a lot on this panel. There is a lot behind me.

I am speaking specifically of Alvin Rabushka, an old and dear friend, who has studied the Hong Kong, the Israeli and the U.S. economy. Some would say to death, but I have great respect for Professors Hall and Rabushka.

My old friend, Richard Rahn, has also had a longtime interest in this subject, as have the members of the panel, and a lot of people I didn't see. Mine is just a little piece of that pie.

I would like to share with you from my heart, and from just notes, submit formal testimony as I go back and revise and extend, a habit which I got into when I was in the Congress. I would also like to submit a couple of articles, one by Jude Wanninski on the explosive growth that would take place. He and I believe in a flat tax America.

I saw your comments, Mr. Chairman. I identify with what you said in your opening comments and I would also like to submit a paper by Allen Reynolds, a longtime friend of mine, on the budget consequences of a flat, fair, simplified tax system.

This is the perfect time to be doing this. It couldn't have been done during wartime, hot or cold. During wartime, people are willing to concentrate more power and authority and responsibility on the central government, in order to preserve and promote and protect our freedoms. Wartime is not a good time, therefore, to look at the consequences.

But the Cold War is over; it is gone. We are not at the end of history, but we are certainly at a moment in which I think we can, as Newt Gingrich keeps pointing out, rethink some of our institutions from the ground up. Nothing needs rethinking more than the budget process, our tax system, our regulatory climate and, Bennett and Kemp would say, our monetary policy, certainly trade policy and the things over which this Committee has such incredible jurisdiction, or at least, interest in.

What is bipartisan? President Carter said the tax system is a disgrace, notwithstanding the fact that he couldn't get anything done about it, and I would make the same case in the Reagan Administration when he said it is a disgrace. We got the rates down a little bit. You're too young to remember, Kweisi, but the top rate used to be 91 percent on ordinary income and 92 percent on what they used to call unearned income, as if income from savings is unearned.

That shows you the pejorative context in which we used to look at tax policy in America. The bottom rate was 20 percent. This is back in early 1960 when President Kennedy ran on the idea of lowering the tax rates across the board on all levels of income in order to get America moving again.

Incidentally, Mr. Chairman, and I say this again with a special emphasis to my friends on the Democratic side of the aisle, the Democratic platform of 1960 committed America, listen to this, to a growth rate of 6.5 percent without inflation. We are growing at about 2.5 percent today and the Federal Reserve Board wants to slow it down; they think inflation is caused by too many people going to work. We should go over there and bang some heads together.

Inflation is not caused by people working, inflation is not caused by people building houses or businesses doing business or factories operating, producing riches. Inflation is a fall in the value of the currency, a fall in the standard of our measure of account; i.e., our dollar. It is a monetary phenomenon; it cannot be solved with fiscal policy.

I am for reducing the deficit. I am for balancing the budget. I might have a slight disagreement on how to do that with some of my friends but, nonetheless, the Democratic Party was historically committed to strong economic growth without inflation. The Reagan Administration, in our platform of 1980, committed the country to full employment without inflation, price stability with full employment. I don't hear Democrats or Republicans, other than the ones on this panel, talking much about growth. I am glad to hear Arlen Specter talking about it. Dick Armey is monomaniacal on the idea of growth. But I just thought today this panel ought to hear that this is not a partisan issue, it is a bipartisan issue and growth is at the heart of the American dream.

Today, all we are debating is cutting up the pie. We have got to think about a bigger pie, how do you get the economy bigger, how do you get more people to work, how do you create more opportunities for access to capital and credit, particularly in the minority community?

From Jimmy Carter to Ross Perot, who said he would tear up the Tax Code and write it on a single page of paper, no one got to it. But to Arlen Specter, to every candidate in the Republican party, I would say here publicly, Mr. Chairman, I think the Clinton Administration, notwithstanding their attack on the Armey, Hall, Rabushka Bill, is right now -- I won't say surreptitiously because that has a pejorative context -- looking at tax reform with an eye on a fairer, simpler system. I am just saying that a priori; I know they are.

So this is a perfect time to do it. This is the best moment and the epicenter of this revolution you are committing, Mr. Chairman. Therefore, I am really excited about chairing this Tax Commission. This is a republican commission; it was appointed by Newt Gingrich and Bob Dole, but I hope, I say to my friends on the Democratic side of the aisle, to come up with a product that has bipartisan support. I was going to say elements, but support.

The primary purpose of the Commission is to move beyond tax cuts, tax credits and exemptions, all of which I support right now, including the EITC. Given the current code, we need every exemption, credit, and mortgage deduction, and depreciation schedule you can possibly find. To do what? To offset the adverse impact of high marginal tax rates. But when are we going to get to the point in which we can take a piece of paper, sit down, get rid of all of the exemptions, all of the credits, all the garbage, all the Byzantine, Gucci Gulch influence on the Tax Code and just get to a flatter, fairer, simpler, lower rate?

It has got to be fair, absolutely got to be fair. The distribution tables have to be looked at with a very keen eye on what the burden of taxation is. There is where I want to start.

The central thesis of all tax policy is something that took a long time for me to get into my head. I am not an economist. I just spent my life in pro football as a quarterback and in the Congress working with you. My friend Jack Quinn is not here, but his dad is here and I want to say, for the record, my favorite anecdote of the tax reform was going to the AFL-CIO convention in Buffalo, New York. Kweisi, my District was not a silk stocking Republican district. It was a blue collar, eastern central European Democrat hardworking district that could be represented by you. It is now represented by Jack Quinn and Bill Paxon.

I was at the AFL-CIO convention as a right-wing Republican. That is how I was introduced. I was talking about the Kemp, Roth tax cut. This was about '78, '79. A guy gets up in the back of the room, full of about 2,000 auto workers. (You have never given a speech until you have spoken to the auto workers in Buffalo, New York. It is a tough industrial union not known to support Republicans.)

There were about 2,000 of them there, not too far from my hometown in Hamburg. It was in Lackawanna, New York and I got up to talk about cutting tax rates. Obviously, speaking to a Democratic audience, I was quoting John F. Kennedy, who said it is a paradoxical truth that high tax rates cause low tax revenues and the best way to get more revenue is to bring down the tax rates and get the economy growing again.

That was from the Kennedy speech in November 1962. So I quoted it. You know, Reagan used to quote F.D.R.; I used to quote John F. Kennedy -- good politics in Buffalo. Other than the Pope, John F. Kennedy's picture was on more living room walls than any other picture. I told them what I was going to do.

A guy gets up in the back of the room and says, Mr. Kemp, what are you going to do about the unemployment rate in Buffalo? I said, well, we'll cut income tax rates by a third. But, frankly, if you want to get more jobs in Buffalo, we should just quit debating capital gains taxes altogether and eliminate them, because capital gains is not a tax on the rich; it is a tax on the poor who want to get rich. It is not a tax on wealth; it is a tax on the creation of wealth. It is not a tax on capital; it is a tax on the formation of capital. It is hurting the cities, and the nation. All of the assets of the country are locked up in the hands of wealthy, excuse me, white, probably Republican and Democratic, fat cat contributors to both parties. Unless you liquefy the markets, unless you bring down the rates, you are going to hold all of your assets in an equity position. Then people will go out and borrow to expand a business that they've got collateral; i.e., the value of the asset.

It is a transaction tax, I said. If nobody transacts and sells anything, they are going to "sit on that asset", and go out and use it as leverage to borrow. And so, unfortunately capital is being locked up in the hands of the maturity of the businesses and not going to the young, minority, low-income, poor, women, or entrepreneur. I said it should be eliminated.

The guy says, well, what can we do in the AFL-CIO to help you? I went crazy to find one voice in the audience. I said, well, do you have any capital gains? He said, "no sir, but some day I hope to."

Here was an auto worker who went home at night, worked in his garage, and had an acme engine repair shop. A small businessman, he had one employee and was off and running. The idea of a static condition in life is the antithesis of your party and our party.

Lincoln said, I don't want laws to prevent someone from getting rich, I want the whole nation to get rich. He said, I want the black men to get rich. I think he got shot for that.

This idea of envy of the rich is bringing down the opportunity for the poor to get rich. That is why a flat tax is important. That is why there is a difference, Kweisi, between the incidence of taxation and the burden of taxation. You place the incidence of taxation on capital formation and the burden will fall on the poor and the people without access to capital. Education is capital. What a mother teaches her children or a father passes on to his children, and in my case my grandchildren, is capital. But with capital, if you don't have access to it, you have no hope of it.

To quote Jesse Jackson, and I am the only Republican that can quote Jesse Jackson, "Capitalism without capital is nothing but an ism." It is an abstraction if you are poor, if you are female, if you are black, living in Baltimore or Buffalo, and have to go out and you can't even get a loan.

Banks don't make loans anymore. If you don't have collateral, you don't own anything.

So the system needs to be revamped with an eye on fairness, which is to open up opportunities for access to jobs, property, capital and credit. A thought.

I think, since I am on the Commission, I cannot endorse any one bill. It is no secret I am a fan of and a friend of Hall, Rabushka, Armey, Archer -- anything that gets the rates down.

I offer some thoughts before we go to questions, and I apologize for the passion with which I approach this issue. It is not for the rich; it is for the poor.

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I don't think we can get this economy growing, as the Chairman said, at a maximum level of employment and opportunity and, as I said, get it above 4 and 5 percent without inflation.

Number two, we ought to set as a goal for this country doubling the size of the economy. Arlen Specter said he wants to take a seven trillion dollar GNP to eight trillion. I would like to take it to 14 trillion or 15 trillion by the middle of the first decade of the 21st Century. Just stop and think a moment. Say, here's where we want to go. Step out of the field. Emerson said you can't see the field well from within the field. Step out of the field and figure out what you would like America to look like in the year 2002, '3, '4, '5.

First of all, you've got to have a strong economy -- so let's say full employment. Second, you would like to double the size of the economy; a 14 trillion dollar economy would give you another trillion-and-a-half dollars of revenue. You could pay down debt, pay down deficits, you could finance a lot of necessary spending programs, like repairing the damage that was done in the Republican budget to the United Negro College Fund and Howard University.

I couldn't resist, Mr. Chairman. Those are some necessary spending programs.

Senator Mack. Somehow I knew you couldn't.

Mr. Kemp. Well, I just think there are some necessary spending programs and there are some unnecessary spending programs. I hope you have the Solomon-like wisdom to figure out what is necessary and what is unnecessary.

But I don't think balancing the budget was enough for the party of Lincoln and certainly not enough for the party of Roosevelt and Kennedy. The one thing about which we can agree.

So how do you get the economy to 14 trillion and full employment as opposed to seven or eight trillion and 5.5 percent unemployment? (In the macro and among minority men and women, the unemployment rate is in the double digits, and among teenage populations it is obscene.)

I want to go back to the point that I made earlier, Mr. Chairman. There is a difference between the incidence of taxation and the burden of taxation and I think Rabushka and Rahn will give strong evidence that a lower rate will remove the burden on the poor.

I agree with Kweisi Mfume. The purpose of bringing down the tax rates is to relieve the tax burden on the middle income working men and women of America and the poor. That is the purpose of it. If it doesn't relieve the burden, don't do it. I will say that emphatically.

If reducing the rates toward a flat, fair, simple, Tax Code, and a postcard-like tax form, doesn't relieve the burden on the poor and the working men and women of America, it shouldn't be passed. That is why, whatever we do, there ought to be some thought given to the Hong Kong model, Mr. Chairman. Hong Kong and Singapore have the two fastest-growing city economies in the world. Compared to D.C. and New York -- they have low rates of taxation on capital and labor. Washington D.C. and New York have high tax rates.

Look at Japan and Switzerland compared to Brazil and Russia. Japan and Switzerland encourage the formation of capital. Russia and Brazil discourage it.

Every country in the world is looking at tax reform. I got a letter yesterday from Paco Hill Diaz, he is the Vice President of the Banco de Mexico, talking about tax reform for Mexico that would eliminate the capital gains tax and bring down the rates.

Eddie Seaga, the former Prime Minister of Jamaica, said he is interested in these hearings and wants to help by giving evidence that a highly progressive income tax rate destroyed Jamaica. The IMF destroyed Jamaica by imposing upon them a 91 percent marginal income tax rate that raised no revenue from the rich. All the rich of Jamaica went underground to get tax-free annuities and other means to escape taxation. They will do it again in the United States as they did in the 1960s and '70s.

I also met Anatoli Chibiaz, a privatization minister in Russia. The tax rate on an entrepreneur in Moscow today approaches effectively 90 percent. Therefore, the whole underground economy of Russia, the whole economy of Russia, is underground. They don't get any revenue.

You don't get any revenue, Kweisi, from a 90 percent tax.

The point of this hearing is to find the level of equilibrium at which people are willing to maximize their output and still pay tax. I think in peacetime, it is closer to 25 than to 45. I like 20 as a round number. It is biblical; it comes out of Jewish history. It was Joseph's answer to Pharaoh how to get their economy into seven fat years. He told the Pharaoh, after he interpreted the dream, to cut the tax from 90 to 20 to get the economy going -- because it was the economy, stupid. Well, you've got to read between the lines.

(Laughter.)

Mr. Kemp. Look, a progressive income tax rate is not progressive, it is regressive. I will stop with this analogy.

Imagine a tax code, Kweisi, in which all of your output would have been taxed at 20 percent on Monday, 30 percent on Tuesday, 40 percent on Wednesday, 50 percent on Thursday, and 60 percent on Friday. On Saturday, if you want to work, everything you produced would be taxed at 70 percent.

Ask yourself just hypothetically how long during the week would you continue to work? At what point in the week would working continue to pay off commensurate with the reward for leisure? That is the tradeoff in the Tax Code. That is what is called marginal analysis.

That is why people do not understand, Connie, the difference between the marginal tax rate and revenues. That is what I think this Committee can do, help people understand that when you talk about reducing tax rates, you are not talking about reducing taxes, you are talking about making the system more efficient, more effective, flatter, fairer, and simpler. Again, I don't have the final answer.

I admire the people behind me, as I said. I think in peacetime, it ought to be closer to 20. There should be no tax on the poor. Any working man or woman trying to escape poverty or get off of welfare, ought not to have any tax on his or her income up to a level of nominal income that would give them five steps on the ladder before they even hit the Federal income tax.

That is the way it has been in America. We have inflated away the value of every exemption. We tax the family heavily. We tax labor heavily. We tax capital, in some cases over 100 percent, effectively.

If you want to make a contribution to this country and to all of the social and economic goals of our nation, then we will reach critical mass here in the last part of the 20th Century headed into the 21st Century. I think this issue is the one to explore and I applaud this Committee for having the audacity to not only hold the hearings but to come out with your findings.

Thank you for letting me wax passionate, if not poetic, for the need for a new tax system in America.

Senator Mack. Jack, we appreciate your statement and your passion as well. I would turn at this time to Congressman Mfume.

Representative Mfume. Thank you, Mr. Chairman.

I have a lot of respect for Congressman Armey and Senator Specter, but I would be less than honest if I said I came over to today's hearing to hear their side of this. I think I heard it. Maybe it is the way it is presented that causes me to still have concerns.

I really wanted this morning to get an opportunity, quite frankly, to hear Jack Kemp, who it will never be said is stoic, reserved or measured.

(Laughter.)

Representative Mfume. I try to stay way from his animation and his passion because sometimes he finds a way to convince me on a number of issues, although I am not yet convinced on this one, Jack. I still have concerns.

It is sort of like the way President Ronald Reagan was describing you to a reporter shortly after I got here. We were both serving in the House. You had said something on the Floor, and the reporter was trying to get some sort of reaction from President Reagan.

He just shook his head and said, well, you know, he is a true believer.

Indeed, you are a true believer. I think more than anything else, the honesty that you bring to explaining your belief in this and your passion about this is something that all of us probably can learn from on both sides of this issue. It is a very, very tough issue and it is a very interesting issue, you know.

I, like you, am not an economist. I tied myself to these economic issues over the last nine years to get a better understanding of them. As I mentioned earlier, and I think it is important to point out, the real tests I think this tax has to meet in order to be accepted are whether or not it will lead to improved economic performance, whether or not it is fair and is it really simple. I welcome the opportunity to discuss these issues with you.

I wish also that this was going out across America so that people would start forcing themselves, because of the discussion, to focus more on the issue and not react to the issue somewhere later down the road.

When you look at the report from Citizens for Tax Justice, as I do, and read the Treasury report, when you hear some of the independent analysis by independent economists who have reservations about this, it causes one (or at least I think it should cause one, regardless of where they are) either to get those illusions and doubts out of their minds and have them all satisfied, or to just leave the idea alone. So I want to listen more than I want to talk this morning.

I am very glad that the Chairman has convened us on this matter and I hope that this Committee, that I used to chair at one point in time, will continue in that vein. I don't see this as being just the domain of House Ways and Means Committee, or the Finance Committee. I think this Committee has a special role because of its makeup, because of its charge, quite frankly, to lead us in the direction of where we are going on this, to entertain the very serious and real doubts and concerns that some of us have, and to try to help foster the dialogue. It is only dialogue that is going to clear the air on this.

So I thank you for your testimony. I will sit back and spend a short period more. I am sorry that I will not be able to hear the authors. I am reading the book, however, and I do hope the Chair will lead us again with this sort of a hearing, convening it so that we might talk more about this issue.

Mr. Kemp. Before you leave, could I make one comment about the Treasury study and the Citizens for Tax Justice? I think their concerns should be widely explored and, as I said earlier, I would not support this, the idea, the concept, without wanting to fine tune the system to make sure that it does not place a burden on the very people that I believe you are concerned about or about which you are concerned, first.

Second, I think there are some politics in their studies. But that's all right, there are some politics in my analysis.

Third, I think without endorsing Hall, Rabushka or Armey, I believe that Professor Rabushka will provide the distribution tables that can answer some of these questions. Finally, if there are inequities, they can be removed.

I am simply making a case that the tax rate system in America is a disgrace, A, and B, the rates are too high on everybody. They are the highest on the poor.

If a woman leaves welfare and takes a job, she loses her welfare and health benefits, and they tax her income. And she's in -- some people have analyzed this; Art Laffer of the Laffer, Kantel Associates in San Diego estimates -- a 130 percent marginal tax rate, marginal being the rate at which you face when you make an additional dollar of income, that's the dollar that is marginal. The straw that broke the camel's back was not the straw load; it was the last straw.

Getting that straw removed means that the camel can carry a big load. Getting the marginal rates at a level of equilibrium, in my view, would lessen the burden on this great economy of ours and help it perform better. Frankly, think, as Dick Armey pointed out Kweisi, the rich will pay more tax at a 20 or 25 percent rate than they will at a 40, 50, 60 or 70 percent rate, because right now monies are doing well, municipal tax-free bonds are doing great.

Representative Mfume. Let me ask you, since you brought that up, Treasury suggests that if you are making $200,000 or more, that the change in your Federal taxes would be negative 28 percent, yet, on the other end of the scale, if you are making between $20,000 and $30,000, it is plus 26 percent. If we scale out politics --

Mr. Kemp. Take out politics -- take out that analysis and make sure that when it comes out in the end there is fairness and equity for everybody.

Now, I remember my favorite debate, with George McGovern in 1972. If you remember, Kweisi, he had a tax cut that was designed for the broad middle class. I think in 1971, 70 percent of the American people earned less than $17,000 or $18,000 a year, and he was going to give everybody $1,000 tax credit; i.e., tax cut. He dropped in public opinion with this demography program and after the campaign was over. I was at Vanderbilt University with McGovern, for whom I have high regard. He is an honest to goodness bleeding heart liberal and I like to think I am an honest to goodness bleeding heart conservative. We had a passionate debate about how to help the poor and he came up with this demography program again.

I said, Mr. McGovern, why do you think it dropped so precipitously in public opinion after you offered 70 percent of the American people a $1,000 tax cut if they earn less than $17,000 a year? He said, you know, Kemp, I just didn't realize there were so many people earning $17,000 a year -- Kweisi, I want you to hear this, the punch line -- who some day hoped to earn $18,000. I would take a temporary tax on my income at, say, $30,000 if I knew that the next dollar of income would face a lower rate than it does right now. That is the key.

You are not statically conditioned to stay where you are; you have a chance to climb. And if you are rewarded for climbing...

Senator Mack. I am going to have to interrupt here.

Representative Mfume. Mr. Chairman, could I ask unanimous consent for an additional minute just to pursue one point that Jack raised?

Senator Mack. I am not sure that the two of you can carry on a conversation in one minute.

Representative Mfume. I can.

(Laughter.)

Mr. Kemp. I give up the last word.

Representative Mfume. Thank you, Mr. Chairman.

I thought what "did" McGovern in was the 100,000 percent behind your statement regarding Senator Eagleton. That was before your time, Jack.

Tell me, if you strip out politics from this whole scenario, isn't there a difference in terms of what the very wealthy would pay and what those who are not wealthy, who earn 20 to 50 to $60,000 a year. Do you in your analysis come up with the same kind of difference?

Mr. Kemp. No, I come up with different numbers than the Treasury Department. Under Hall, Rabushka, if I remember correctly -- you ought to ask Professor Rabushka this, or Richard Rahn -- the effective tax on $50,000 of income would be in the 4 percent range. Once you get over 200, you hit the 17 or 19 or 20 percent rate. So, again, the rate of taxation over $50,000 of income may be taxed at 17 percent, but the effective tax burden is reduced to around 2, 3 or 4 percent. I don't know what it is.

So, in effect, there would be a rate reduction for everybody, albeit a flat rate. It is graduated at the bottom. With a flat rate, say 20 percent and an exemption of income up to about $36,000 for a family of four, that family would not face an effective rate above 4 or 5 percent until they reached income levels consistent with upper income. That's the key.

Representative Mfume. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR ROBERT BENNETT

Senator Bennett. Let me get into this briefly before I get into the issue I want to deal with and say to the Congressman the flaw in the Treasury study from my point of view is their inability to predict behavior. It is one thing to sit there with a computer and do a calculation of still numbers but the rich have options that the poor do not have and the assumption, if I could say to the Congressman, the assumption that the Treasury is making is that the rich will not exercise their options under one system that makes it possible for them to avoid taxation.

Now, I am not an economist either but I have had the experience of going three years with no income and seeing my debt spiral into scary kinds of proportions and I was afraid I was going to lose my house. I am an entrepreneur, which is a much scarier thing than being an economist. And of the businesses I have founded, more have failed than have succeeded so I know what it is to miss mortgage payments, I know what it is to get angry phone calls from the American Express Collection Agency at dinnertime. They always call at dinnertime because that is when they know you are going to be there. I know what it is to be thinking about what's going to happen to my children's future because I have no assets.

Some of my businesses have been successful and I know what it is to sit down with a tax consultant and have him say, now, this is how you can avoid all taxes altogether with this particular tax strategy.

I say to the Congressman, the Treasury study is flawed on that basis, that the Treasury people, as they make their projections under one system and another, are ignoring the ability of the rich to change behavior under one system and avoid taxes and in fact they are getting caught, if that is the proper verb, on the flat tax because they have no place to go.

And you can say, oh, yeah, if the rich behave this way, they will pay more tax significantly under the present system than they would under the flat tax but the fact is, having been poor and having been rich, I tell you they don't behave that way and the people with no options are the poor people and they are the ones that are getting hammered under the present circumstances far more because they cannot buy municipal bonds, they cannot set up the pass-through trust, they cannot buy the single-payment life insurance policies that allow all of the income to accrue within the policy and then it gets redeemed in the next generation when it gets passed on.

All those wonderful devices that I didn't know about when I wasn't earning any money and suddenly thousands of people are coming at me to try to explain to me now. So I put that into this debate that you and Jack Kemp have had.

Mr. Kemp. The Treasury isn't the only organization without a behavioral model; CBO doesn't have a behavioral model. You should have econometric models here.

Senator Bennett. I got trapped blaming CBO for that and the Chairman brought me up short in the Appropriations Committee. It was the Joint Committee on Taxation.

Senator Mack. The Joint Committee on Taxation is the one that was making those estimates.

Mr. Kemp. Everybody is making static analyses. They assume nobody changes their behavior.

Senator Bennett. Let me go to another issue that I think is very fundamental in this debate on the flat tax. If you talk about the lower half of the people earning money, whether it is the poor or the lower end of the middle class or whatever, their largest tax burden right now, as I understand it, is not the income tax, it is payroll taxes. We have this myth in this country that the employer contribution is not the employee's money. Having been an employer, I can tell you and the world that all of the money that is spent on behalf of the employee in the name of the employer contribution, whether it is for health care or for Social Security or for Medicare trust payments or unemployment compensation insurance, it is all earned by the employee. Because if the employee is not bringing in enough economic benefit to the company to be able to afford the "employer's share," the employer is going to discharge that employee.

Now, if you take the employer's share and the employee's share of these kinds of contributions and put it as it really is, which is a tax, we have employees who are paying right off the top dollar of the economic benefit they are creating, 15, 16 percent plus, right now, before you get any income tax at all.

That is my concern about this flat tax circumstance. Is it going to address and solve that problem so that if you go to the numbers that Arlen Specter gave us, I pick on him because his is on the top, he says in the sample 1040 postcard that he gives us in his testimony he says wages and then you have an allowance, $16,500 for a married couple filing jointly, let's say they have no children so there are no allowances there, and that comes off. So let's say somebody is earning $16,500, a married couple filing jointly. That puts them pretty far down the chain. Here is the allowance of $16,500 and he says, hooray, these people don't owe income.

Oh, by the way, the payroll taxes on that $16,500 is going to be about 15 percent. Are you going to address that on your Commission? Are you going to talk about that? Does that have anything to do with all of this?

Mr. Kemp. Absolutely. I mentioned it in my remarks as one of the greatest deterrents to helping poor people get out of poverty.

I would be fascinated to read the results of Richard Rahn and Alvin Rabushka and other people testifying and what they say about allowing people to deduct. That is one reason why I have supported the EITC to offset the payroll tax because I don't think you can run an enterprise zone without off-setting this terrible marginal tax rate on a woman who leaves welfare or a father that leaves unemployment insurance and takes a job.

The Senator is exactly right. I think the point he introduced, Connie, is something that almost is going to take, Mr. Chairman, a whole hearing: the behavioral response.

I don't want to sound like B.F. Skinner; I'm not a behavioralist -- but there are responses that not only the rich make to the Tax Code but labor, working men and women, entrepreneurs and the poor. They calculate, they are as smart as anybody else, they make rational calculations about whether or not the reward for work exceeds the reward for welfare and I am convinced that that should be borne in mind as we go through these hearings.

Predicting behavior when they put on the luxury tax on automobiles and boats, the Bush Administration calculated millions and millions of dollars. All it did was to destroy the boat industry in Connecticut, New Jersey, Rhode Island, New York, Florida, and Maryland. It lost jobs and revenue.

When we raised capital gains in the 1986 tax law, everybody said, "Oh, if the rich continue to do what they have done, we can take the rate up from 20 to 28." I will never forgive myself for being a partner to that legislation. Revenues did not come in; revenues went down on capital gains.

Frankly I think we should consider, Kwesi should hear this, no capital gains tax, no estate tax, no double taxation of dividends and the total expensing for any business in America, large or small. Their investment in plant, machinery, equipment, technology and this whole information age technological improvement --

Would the economy grow? I sit back, Kweisi, I don't have a model, but I will guarantee you, you will be sitting at the most explosive economy in the history of the world. Well, that is Kempian, a little global. But everybody else would try to match it.

Senator Bennett. I see my red light is on. I would just ask the indulgence of the Committee to make one other quick point.

Senator Specter in his proposal on the flat tax puts an exemption for mortgage interest. He says, and I agree with him, that that makes it much easier politically to pass it and Senator Specter is nothing if not a pragmatist. There is, however, another reason to think about including interest deductions even in the flat tax. For better or for worse, we have created a circumstance with the mortgage interest deduction whereby the value of homes is anywhere from 10 to 15 percent higher than it would otherwise be if that were not there and that is built into just about every homeowner's financial plan and sense of financial stability.

If you were to eliminate it, it would have the effect, economic effect, of slicing about a trillion dollars in aggregate wealth out of the lives of average Americans. We saw in the 1986 act what happened to the savings and loan industry when you destroyed the value of the collateral.

Now, speaking in purely economic terms, the collateral was inflated for tax purposes and that is not right but without a phasing in circumstance, you suddenly said to your local S&L, by the way, all the collateral you have is suddenly worthless because of the way we have changed the Tax Code. I don't want to do that to the American homeowner and I don't think this Congress could stand the political backlash that would come if everybody's home was effectively worth 15 percent less overnight.

Mr. Kemp. Luckily for the Committee, I've got to catch a plane so I am going to leave but I do want to comment on that last point that Senator Bennett wisely made.

Again, I would be interested in what Rabushka says about this. I am the number one advocate, maybe next to you all, of ownership of housing and raising the value of people's primary asset, (i.e., their home), no matter how humble. That is the dream not only of America but of the whole world.

Nelson Mandela announced two weeks ago in Johannesburg, South Africa, he is going to privatize all housing. I couldn't do it in the United States of America, but Nelson Mandela is going to get to do it. He knows. So you are absolutely right, Senator.

Why can't you grandfather the people? -- You could grandfather them. But in the right type of a Tax Code, in my opinion, not only would the value of stock, equity, debentures, bonds, financial assets, and physical assets, all commercial properties rise in America -- if you have no capital gains tax and no estate tax, the value of all residential property in this country would rise. In fact, low income people would get access to that property if we would do the right thing at HUD and privatize all those public housing places instead of blowing them up.

Your Administration is doing. We should have privatized it, giving them a chance to own.

Representative Mfume. Jack, you know and I know that's an hour-long debate between us. I don't mind privatizing public housing if it is done right.

Mr. Kemp. Mr. Chairman, I made the point. I just remembered my postscript. I've got to put it for the record because if I don't, all my supply-side friends will call me and wonder why I wimped out on this issue.

Lowering the tax rate on labor and capital, the type of code toward which we are headed, would strengthen the dollar, it would allow the Fed to conduct monetary policy with an eye on lower interest rates, because it would strengthen the demand for the dollar. Unfortunately, too many people in this country think that the Fed just works on the supply side of the dollar and not on the demand side of the dollar.

It would strengthen the demand for the dollar, interest rates could come down and, as Bennett has pointed out so eloquently in the Senate, every 1 percent drop in the interest rate of the United States long-term bond market removes the deficit. I think, Bob, you told me this morning $47 to $48 billion.

You want to balance the budget. We are nickeling and diming the budget. We should be making the dollar as good as gold.

Thank you.

Senator Mack. Thank you very much, Jack. Have a good flight.

(Laughter.)

Senator Mack. The next panel will come forward. We look forward to your testimony.

(Pause.)

I want to welcome all four of you and thank you for your patience to testify.

Again, I think for the sake of time, rather than going into individual introductions, I will put introductions into the record.

[The introductions appear in the Submissions for the Record.]

Senator Mack. We will begin with Mr. Rabushka. If you will make your opening statement. We will move on from there.

PANEL III

STATEMENT OF ALVIN RABUSHKA, PROFESSOR, HOOVER INSTITUTE, STANFORD UNIVERSITY

Mr. Rabushka. Thank you, Mr. Chairman, Members.

In June of 1982, the first modern flat tax hearings were chaired by this Committee. This is coming around to the 13th anniversary, which happens to be my lucky number. So I am delighted that you have chosen to again engage in this particular subject and I thank you for the invitation.

I did submit a short written statement which is basically taken verbatim out of chapter four of my book, which I think you know about. Any Member of Congress who is interested in the subject and doesn't have one, I am happy to provide a copy. And for anyone in the audience, call 1-800-9FLATAX, which is the Hoover Press number and they will be happy to sell you one. Buy them in bulk and you will get a discount.

What I wanted to do in a few minutes is to focus on those aspects of the flat tax which bear on the subject of discussion, today which is economic growth. There are going to be two rounds of hearings tomorrow. There will be rounds of hearings in June and no doubt July, and all through the fall. I would guess that through all of those hearings, taken together, every aspect and every issue surrounding the flat tax will be raised so I would like today to narrowly focus in on the issue of growth because in my view, the obsession with distributional tables, the obsession with winners and losers, basically overlooks that growth makes everybody a winner and to be trapped in a world without growth is to be trapped in a world where all you can do, as Jack said, is divide up the pie.

In the plan that my colleague, Bob Hall, and I devised originally in 1981 and has remained more or less intact, save we have adjusted numbers over time to take into account growth and inflation.

The central feature in the flat tax that we have laid out is that it is a single tax that is taxing income flows once, on a base of consumption. I don't like calling it a consumption tax because I think that muddies the water on issues like the sales tax and the value-added tax, but I want to be clear the base is consumption.

And because the base is consumption, the expensing provision in our plan, and in the plans Specter and Armey are proposing, mean basically that the economy does not tax each year the net increment to capital. This is the kind of encouragement to investment one wants to have and it takes what is today pages and pages of complicated depreciation schedules, two-year, three-year, five-year, 10-year, 15-year, pre-'86, post-'86, pre-'94, it's a nightmare even with a computer program, and replace it with one line. Did you invest it? Write it off.

That is the provision that makes the tax base consumption and which is encouraging to growth and investment.

The second thing I would like to focus on, and it is important also, is the importance of eliminating the double taxation of business income. I think that may be among the most abusive forms of the current tax code. What that really means is today that the tax rate on business income can reach as high as 60 percent on the margin, whether it is through the double tax on dividends, or the double tax on retained earnings and what we call a capital gains tax. So I think it is critically important to get the uniform rate down. We recommend 19 percent. We can live with 18, we can live with 17, we can live with 20. Not with 21 but from 20 on down, the lower the better.

Another issue of the flat tax which is critically important in my view is that the rate is low. We are not in favor of a high flat tax, we are not in favor of a medium flat tax. We are in favor of a low flat tax. The reason is very simple. Low rates of tax will release human energy and encourage risk taking.

Now, a third point which I think is very important to growth is that today we take about 500,000 of the most talented people in this country, tax lawyers, tax planners, tax accountants, financial planners, sellers of shelters. These 500,000 people earn very large incomes and what do they do? All they do is reduce taxes on millions of people who happen to be very successful in their business life, their investment life, their working life. They don't produce anything; they just simply reduce the taxes of others. The redirection of some of the country's smartest and hardest working people out of reducing taxes for others would have a great, great success.

Now, in terms of the consequences for growth, let me just simply say, and Professor Kotlikoff is one of the sources we rely upon, that when we have aggregated and looked at all the studies we can find in the last 10 years that examine the labor supply, the capital supply and the entrepreneurial supply and take the lowest, most conservative result, we would expect at least a 6 percent output in growth per capita over seven years, almost a 1 percent increase in the growth rate of the economy, which boils out to coming close to $8,000 for a family of four, which is a huge, huge increase.

The second aspect is we would completely remove the Tax Code from all economic consideration. Nobody would think about taxes, and citizens would engage in productive economic activity. I have been told by thousands of people and dozens of audiences that for a flat rate below 19 percent, "I am not interested in fiddling the Code, I am interested in producing more income."

As I said before, half a million people would become productively more active.

I see the red light is on and so I will stop at this point.

[The prepared statement of Mr. Rabushka appears in the Submissions for the Record.]

Senator Mack. You are the first one who has reacted that way.

Mr. Rabushka. That is what I understood the red light to be: Stop.

Senator Mack. I appreciate that.

We will go to Mr. McIntyre next.

STATEMENT OF BOB MCINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. McIntyre. Thank you, Mr. Chairman. I appreciate the opportunity to be here, my first appearance before the Joint Economic Committee, so it is historic for me, I guess, like it is for Alvin.

The question before the Committee, as I understand from your letter, is: how would a flat tax plan, a plan to raise taxes on most Americans and cut them on very wealthy people, affect the economy?

Fortunately or unfortunately, I think we have a case study to look at to answer that question. The supply-side tax changes of the Carter and early Reagan Administrations were a test of whether it is a good idea to raise taxes on most people and cut them for wealthy people in terms of economic growth. What we learned from those days, what President Reagan learned in particular, is that it is a terrible policy, that in fact the idea that we can shift the tax burden away from those with the most ability to pay and somehow therefore lead to a more productive economy is simply wrong. It failed in the past, it would fail again and we should not repeat those mistakes.

Let me just say at the outset that there is not very much disagreement despite what you heard this morning, among serious people about the distributional effects of switching to a flat tax.

Senator Mack. Can I ask you a question? How do you identify serious people?

Mr. McIntyre. I think everyone who works in this area doing distributional analysis has reached the same conclusion, whether it be the Reagan Treasury Department, the Congressional Budget Office, the current Treasury Department, or the authors of the "Low Tax, Simple Tax, Flat Tax" book of 1983. In other words, everyone who has looked at it and done distributional analysis.

Senator Mack. Mr. McIntyre, the only point that I am making is there are going to be some people who disagree with you this morning. The implication is that somehow they are less serious than you are.

Mr. McIntyre. I think some of the people I have heard today who have disagreed are less serious in the sense that they are not equipped to make these kinds of analyses. Everyone who has done a serious analysis that I have read has reached exactly the same conclusion.

I would count as a non-serious analyst someone who said, well, I haven't done any work in this but I think it would come out this way. That would not be serious.

Someone who has done serious work, if they disagree, I haven't read their studies. That is my point.

From Hall and Rabushka in their 1983 book to the Reagan Treasury Department to the Clinton Treasury Department, to some work we have done, to the Congressional Budget Office looking at Jerry Brown's flat tax plan to pure common sense, all reach the same conclusion: if you lower the tax rates on the richest people and you tax far less of their income, that is going to be a huge tax cut for the rich. And that is what these flat tax plans are about: more loopholes for the wealthy and lower tax rates for the wealthy.

Having done that, assuming you are going to break even, someone has to pay more. That someone, rather clearly, is everyone else, particularly the middle class.

Now, we have gone through in our testimony some detailed examples. Because it is frustrating to listen to people like Representative Armey say, well, you should only look at the wage part of my tax. The business part is paid by no one. He says that over and over and over again. But the business tax, the consumption tax at the business level is in fact paid by someone. It is paid by people on their fringe benefits, it is paid by people on their Social Security taxes which are taxed under the Hall, Rabushka plan and it is paid on their spending.

When you add those components together -- and we have examples on page four of our testimony, detailed examples that show you based on tax returns and census data what people would pay -- it is very clear. People at the bottom won't pay the wage tax, but they will lose their earned income tax credit, which is a very, very large tax increase at those levels, and they also will pay the fringe benefits and sales tax parts of the plan.

You can't pretend when you are taking away, for example, for a $15,000 family, $3,300 in income tax credit, which is what Representative Armey and Senator Specter would do, that that is not going to be a tax increase. In fact, of course it is.

Up the income scale through the middle, all the way up to the upper-middle, taxes go up under the flat tax. When you count all the pieces of it, including the wage tax, the fringe benefits tax and the business consumption tax, only for the highest income people do taxes fall.

If that is the impact of the plan, and certainly those are the results that everyone who has looked at it and published a distributional table has found, is it a good idea? As I said at the outset, it is an idea that has been tried before.

The supply-side tax bills in the Carter and early Reagan Administrations were designed to do exactly what these bills now proposed are designed to do, lower the tax on capital. For example, the 1981 bill let businesses effectively expense their capital investments and that was supposed to lead to increased economic growth. Instead what happened after each of those supply-side changes is that the economy went into the toilet. Eventually, Ronald Reagan himself realized it was a terrible idea. He switched gears in 1986, repudiated the loophole-based, no-tax-on-capital strategy, restored the corporate income tax, and made taxes with lower rates simpler and fairer, which is what we favor.

The result of it was the economy boomed, led by investment growth. That's a fact.

You can say, well, it was despite the '86 reform act. You can say that the economy having the worst recession since the Depression in '82 was despite the '78 through '81 changes. But the fact is that the people who promoted those loopholes, who are here today, promised that if we cut taxes on capital we would get wonderful economic results.

We are hearing them today. Jack Kemp says we are going to double the size of the economy. That is not a serious analysis either. It is not going to happen. We have tried it and it failed.

So what should we do? Is the Tax Code perfect today? No. Of course it is not perfect. Because in part of political pressures that would, by the way, apply to a Hall, Rabushka flat tax as much as any other tax system we have, our Tax Code is riddled with special tax breaks for the politically powerful. We propose closing those down, not consolidating them all into one gigantic loophole as is being proposed by the flat taxers.

We just published a study, Mr. Chairman, listing the $456 billion worth of tax breaks and suggesting which ones of those ought to be under scrutiny by the Congress as it tries to balance the budget. We think a lot of them should be. Most of the reforms we favor, however, move in the opposite direction from a flat consumption tax.

Senator Mack. I appreciate your testimony. Your time is up.

I would suggest to you that there is a Reagan Treasury official 80-page document in the Columbia Law Review, an argument about why distribution tables are flawed. You might want to take a look at it.

Mr. McIntyre. I have read Mr. Gratz.

Senator Mack. So he is not serious?

Mr. McIntyre. He is a serious person, a very frustrated one, but he does not do distributional tables either.

[The prepared statement of Mr. McIntyre appears in the Submissions for the Record.]

Senator Mack. We will now have an opportunity to hear from Richard Rahn.

Mr. Rahn, thank you for being here this morning.

STATEMENT OF RICHARD RAHN, CHAIRMAN, THE BUSINESS LEADERSHIP COUNCIL

Mr. Rahn. Mr. Chairman, Members of the Committee, thank you for inviting me today. I am testifying today on behalf of The Business Leadership Council. I am an economist but also an entrepreneur.

When the Senator was talking about the ups and downs of the entrepreneurial life, I can identify with that.

I ask that my entire statement be made a part of the record. I will quickly summarize a few of the key points.

I think a couple of points that Mr. McIntyre just stated need to be corrected. There is a history. Mr. McIntyre and I have been on various panels before the U.S. Congress for the last 17 years or some such and if any of the Committee staff would like to go back and take a look at his testimony, starting off with the Steiger capital gains tax reduction in '78 and mine in '78 and '81, with the '82 Act, the '86 and so forth, there is a good deal of evidence about who is serious and who is not.

Mr. McIntyre has not even had the direction of his signs right for the changes in the capital gains tax. He just told you the Reagan policy was a failure. I think virtually everybody in the world knows, except for a few people on the left end, that we had seven fat years of unparalleled economic growth. Once the tax rate went in effect in 1983, inflation came down, unemployment came down, Americans were far better off. There is empirical evidence from around the world that a number of these folks try to ignore about what works.

Reducing tax rates, the regulatory burden, bringing down government spending as a percentage of GNP works, it has worked here, it has worked in virtually every other country in the world.

You know, there was the Keynesian notion that a lot of us were taught when we were in school that ever-increasing government spending was good for us. Starting 25, 30 years ago a number of us learned that Milton Friedman and Friedreich Von Hayek and many others were the ones who were right, not Lord Keynes. This is now the accepted wisdom throughout the world. This is why you had the big change in England, why you had the booming economies in southeast Asia. I have here a chart that is at the back of my testimony.

This is based on a lot of empirical work of a lot of very serious people, serious economists unlike Mr. McIntyre who have done a lot of empirical work from around the world and who have some notions of the type of performance that we can expect.

Why has this Congress and even the Clinton Administration talked about downsizing government? The budget bills you have before you will bring down federal government spending to about 18 percent of GNP and when you include state and local government spending it will be down to about 30 from the current 34.

Now the reason that we are moving in that direction is not because you are mean-spirited, it is because you understand to better the lives of everybody, to increase economic opportunity, particularly for the people at the bottom-end of the wage scale, you have to reduce the size of government.

The problem I have with my friends Alvin Rabushka and the rest of the flat tax advocates is, that they are forced to come up with a static revenue basis for their rates. That presents certain problems.

To have this kind of change, we ought to have many more winners than losers, make virtually everybody a winner and we can do that with a maximum tax rate of no more than 15 percent. That would give us the kind of economic growth that the previous witnesses have talked about. It would actually bring adequate revenue into the federal government to fund those programs. We are not talking about reducing the absolute dollars, you would be broadening the tax base even further and it would greatly reduce some of the problems you will have in economic transition with the Rabushka, Hall, Armey plan or any of the other plans. That is the way we think the Congress ought to go.

You have an opportunity now to do something fundamental because the present tax system is dysfunctional. People hadn't realized the electronic revolution which is coming along, with the new smart cards and electronic transfers around the world it will be very easy for people who don't want to pay taxes on capital for some reason to evade it. You can either move into a totalitarian type of regime and try to restrict all these folks or you can move toward a flat tax, consumption-based type taxation system, sales tax, flat tax, whatever, and capture a reasonable amount of revenue without the kind of intrusive IRS which is not compatible with a free society.

That, Mr. Chairman and Members of the Committee, is the way we urge you to go. Thank you very much.

[The prepared statement of Mr. Rahn appears in the Submissions for the Record.]

Senator Mack. Mr. Kotlikoff.

STATEMENT OF LAURENCE KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

Mr. Kotlikoff. Senator Mack, Senator Bennett, I am honored by this opportunity to discuss with you the economic effects of a flat tax of the type originally proposed by Professors Hall and Rabushka. My testimony is going to make five points.

First, the flat tax is a form of consumption taxation and consumption taxation will be very good for the U.S. economy. Its adoption would raise saving and investment, employment output and real wages. It would also eliminate a number of major distortions in our current tax structure, thereby significantly raising U.S. economic efficiency.

Second, the predicted economic benefits from a flat tax are substantial. Generic similations of shifting from income to consumption taxation in the standard neoclassical economic growth model, which is the life cycle model for which Franco Modigliana won the Nobel Prize produce long run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of a flat tax, although much more detailed simulation studies are needed.

A third point is that a flat tax, like other forms of consumption taxation, increases savings in large part by redistributing from older generations with high propensities to consume to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young and the unborn, the flat tax would offset to a small degree the enormous past and ongoing redistribution -- reverse redistribution that has resulted from the expansion of pay-as-you-go entitlement programs and which is primarily responsible for the critically low current rate of U.S. savings.

The fourth point is that the flat tax is a much more progressive tax system than is currently believed to be the case. The reason is that the consumption taxation -- I hope Mr. McIntyre is going to listen to this as well as Mr. Rabushka, because I think that this point is being missed by both sides of this argument -- the consumption tax, of which the flat tax is a form, really represents a combination of a wage tax and a wealth tax. A millionaire under the current income tax system pays tax only on the capital income that he receives. He is not being taxed on the principal.

Now consider a retail sales tax. Under a retail sales tax, when the millionaire spends his millions on a Mercedes or vacation trips, etc., he will be paying tax on the principal. So the consumption tax really has a wealth tax component to it. It also incorporates a tax on wages. If the millionaire were also working and earning money when he went to spend that money, he would be taxed on the expenditures. So taxing consumption really is taxing wages plus wealth.

When you think about a consumption tax as a tax on wealth, then you realize that it contains a very progressive element. This tax on wealth is not being captured in either Congress' or the

Administration's distribution analyses. Even though these analysis are being done by people you would otherwise think are serious, the kinds of distribution tables that have been constructed are not really getting at the true distribution burden of the consumption taxation. There is a very major issue here that is, I believe, being missed in this discussion. By the way, my testimony explains why the flat tax also constitutes implicitly a tax on wealth.

Since most of the inequality in living standards within a generation represents differences in amounts of inherited wealth, the wealth tax component of the flat tax would enhance intra-generational equity.

My fifth and last point is that the U.S. economy needs consumption taxation. Whether consumption taxation should come in the form of a flat tax or a retail sales tax, a personal consumption tax, an electronic consumption tax, a value-added tax, is a question that can provide hours of very interesting debate. Each of the different methods of taxing consumption has its advantages and disadvantages but it will be a tragedy if we fail to adopt one of these methods of consumption taxation because we are locked in a debate about which one is the best one. In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation. My testimony, which I encourage you to study, explains why we are saving a third of what we did in the '50s and '60s, specifically, it explains that our decade-long process of transferring from young savers to old dissavers is at the heart of our declining rate of national saving.

If you look at the consumption of the elderly relative to young people on a per capita basis, it has almost doubled since 1960. The real reason we are saving so little is because the older generations are consuming so much.

My testimony goes on to explain why the flat tax represents a tax on consumption. Alvin was indicating that we are taxing income minus investments, which is income minus saving, which is what we call consumption. So with a flat tax you are indirectly taxing consumption. Mathematically speaking, this is just the same as taxing it directly in terms of any reasonable economic model.

If I have run out of time, please let me know? Or can you let me go on for a second.

Senator Mack. Go ahead.

Mr. Kotlikoff. Just for a minute or two.

The testimony talks about how the flat tax taxes wealth. According to the original Hall, Rabushka proposal is to eliminate when the businesses try to sell their asset, the flat tax would tax the sale proceeds but it would not allow a deduction for the basis. So if you have an asset, let's say it's a drill press worth $1,000 with a basis is $1,000, there is no capital gain. Under the current tax system, we would be taxing capital gains and if the business sells the asset, it would include in its taxable income the capital gain which is assumed to be zero. Under the flat tax proposal, the business again includes the sale value of the asset, the whole $1,000, but there is no deduction for the basis. So you are not taxing capital gains on the asset, rather you are taxing the principal. Even if the company doesn't sell the asset, the market value of the company will fall.

So when you look really at the way the consumption tax operates, it is in part a tax on wealth and the reason why there is an intergenerational redistribution here from the old to the young is because the old have a larger share of wealth in this country. When you simulate the switch from income to consumption taxation, you see that you are shifting more of the tax burden onto the elderly through this wealth tax component and they have got higher propensities to consume and that is how you get consumption to come down.

Senator Mack. Go ahead and wrap up now.

Mr. Kotlikoff. The testimony has some simulations at the back which simulate this increase in output and real wages and capital stocks associated with going from income to consumption taxation.

Thank you very much.

[The prepared statement of Mr. Kotlikoff appears in the Submissions for the Record.]

Senator Mack. I appreciate the testimony from all of you.

Senator Bennett.

Senator Bennett. Thank you, Mr. Chairman. I will do my best to read through everybody's presentation.

I have some observations. There is absolutely no question that the present capital gains tax structure is holding down investment in this country and I can introduce you, if you are so inclined, to investors who are not making investments because they feel their capital is locked up in one circumstance. They would like to get it unlocked and into something else but they will not do it and I can introduce them to you face to face.

There is no question, Mr. Rabushka, but what business decisions are being made on the basis of tax considerations rather than intelligent business considerations. As a result of that, jobs are not being created, wealth is not being created that would be created.

I can tell you absolutely that for a small entrepreneurial effort that is growing rapidly, the most terrifying thing that can happen to you is to get a big order that you have to book as income and pay taxes on and then go out and borrow money to pay those taxes because there is no way in the world you can afford it while you are funding the increased inventory and the increased investment necessary to make that big order.

I was accused in my business when I was running it of allowing the business to grow too fast and I had people saying, you are going to grow us into bankruptcy because we can't afford the taxes on the profits you're booking. Fortunately, we were able to do it without growing ourselves into bankruptcy for two reasons. We had very good margins and we were a cash business so that we did not have excessive receivables to fund. If we had had receivables to fund, we would have been hit with and destroyed by the tax bill.

This may seem trivial but the business that I took over as CEO with four employees in 1984 now employs over 3,000 people. It is listed on the New York Stock Exchange and has a net asset value of three-quarters of a billion dollars. For the people who depend upon that business for their livelihood, this is not a trivial issue.

We grew, I'm sorry, Mr. McIntyre, in the Reagan years and I am afraid, under the present circumstance, with the tax burden put upon us, put upon businesses by the Clinton tax bill that passed two years ago, we would not be able to grow that rapidly and we would not be able to create that many jobs.

I don't know how that works out on a distribution analysis but I know exactly how that works out on a distribution analysis but I know exactly how it works out on a balance sheet and a Profit and Loss (P&L) statement and I can assure you with absolute certainty that if our business had been trying to grow in the present tax atmosphere, we could not have grown, those jobs would not have been created and that life would not have been created.

So I will read everything everybody has, I will do it as carefully as I can. I can think of no more significant long-term problem that this Congress faces than the question of scrapping, not amending, not changing not perfecting, not closing loopholes, scraping the present Tax Code and putting something else in its place.

I conclude with this comment. During the health care debate, I took the Floor of the Senate to point out that no one could possibly understand the health care bill. I know of only two people who claim to have read it, Pat Moynihan, who told me he took the week after Christmas to sit down and spend the whole week reading the bill --

Senator Mack. Which one did he read?

Senator Bennett. He read the original one.

Elizabeth McCoy who read it and then engaged in the significant debate about what was wrong with it.

I made the point, quoting Madison, that you have to have legislation that people can understand and this piece of legislation clearly nobody can understand. And Senator Moynihan, then the Chairman of the Finance Committee, responded with a comment that I think is appropriate here. He said, in effect, I cannot quote him exactly, well, Senator, we have long since passed that threshold.

The Tax Code is over 300,000 pages long with all of the commentary and other circumstances and there isn't a person on the planet who understands it. So he says, if you are going to insist that we have legislation that people can understand, you are beyond the historical fact. The Tax Code has long since gone beyond the point of any human being to understand it. And I think that is a national scandal, Mr. Chairman. If that is the case, let's repeal it and start again with something somebody can understand.

I am not prepared to endorse any of the flat tax proposals that have been made here today yet, but I believe very strongly that this is the direction in which our intellectual efforts must go because the present circumstance is not fixable.

Thank you, Mr. Chairman.

Senator Mack. Thank you, Senator Bennett, for that comment and also for your sticking with it this morning and participating in this hearing.

Senator Bennett. As I say, I can't think of anything more important so this is where I belong.

Senator Mack. It has been a long morning and I am not going to keep you all too long but it seems to me after listening to this entire discussion that like so many other issues that the Congress deals with, in the end you come down to just a couple of things being the points of debate. And it seems to me that the issue of the distribution tables, because they are going to be used, people are going to say, listen, under this plan, this number of people are going to be losers, these people are going to be winners, and so I think it is important that we hear from you all with respect to if there is someone out there listening who really is not an economist but wants to try to understand about what these distribution tables mean and why using present distribution tables provide an inaccurate data which will draw improper conclusions. I would like to hear from you all with respect to that in language that the aver-age person can understand.

Mr. Rabushka. I am glad you raised that because when the red light came on, that was my next page in my set of notes. It would take minimally a full day to talk through all the issues as to what's involved to do an honest-to-god accurate, professional accounting of what the current distribution is, because the truth is we don't know how the corporate tax is apportioned today and that would have to be factored in, and how it would be in the post-Hall, Rabushka, Armey, Specter, whatever, flat tax world. No organization at this point is prepared to do that, in my view, correctly.

So what I want to do in just maybe two minutes is make three points that are always left out and that I think are crucial and that people who are interested in this debate going forward in a serious, honest way must address. If they don't address them, they are neither honest nor serious.

The first is that the studies that have been prepared looking at the compliance costs, the evasion costs, the enforcement costs, the litigation costs, the lost opportunities, the failure to invest when you should invest, the failure to expand when you should expand, the dead weight burden costs, these run easily in the hundreds of billions. Some come up with numbers as high as 350 billion, some more, some less.

Take a conservative bottom number of 200 billion. That's real money, it's about the size of the budget deficit. Not too far removed from the interest payments, getting close to defense expenditures. It is really honest-to-god money and somehow or other these distributional tables never take back into account that the economy is going to get a huge boost from the tax cut associated with the greater efficiency and savings and release of talent and energy and those savings have to be apportioned in some way, or else we are simply assuming that when we double the price of lettuce from $1 to $5, people buy the same amount and it is not true, they don't.

The second point I think that is essential is to do a little serious academic work on fairness and I have done that. I have done that and I have gone back and looked at the Oxford English Dictionary and old Norse, old Teutonic, middle French, old English and so on. There's basically five pages, triple columns, and from about 865 A.D. when the word first appeared in any of these languages, until about the 1930s, it meant exactly the same thing. What it meant was equal treatment of equals, equality before the law, everybody on the same plain.

About 60 years ago, the concept got hijacked to basically mean the rich should pay more, not only in total terms but at every increase in their income. This is a concept that I think has somewhat fallen into disfavor, which is my third point, because any definition of fair has a half life typically of no more than two years. Were the 91 percent rates fair under Reagan, was the 70 percent rate fair under Kennedy, were the 50 percent rates fair when Eisenhower took over? Was the 28 percent rate fair when Reagan finished? Was the 31 percent rate fair when Bush finished? Was the 39.6 percent rate fair when Clinton finished? The rates don't sit still long enough for anybody ever to say what's fair, what isn't, what is the appropriate distribution.

Then finally, and this is the most important point, and it is what I regard as the single greatest error and the absolute importance of your hearings, is that if you suppose no change in behavior and no growth, it will be the case that you are assuming human beings are immutable, they are inelastic, they never respond to changing circumstances. My assessment of this is, that even on the conservative estimate, there isn't a single scholarly study that has been published in 10 years showing that there won't be growth.

Most show high growth. We took the bottom bounds and that growth would so overwhelm and swamp next year's distribution tables that everybody would not only be better off in a few years, but the future would be better.

Finally, I get a little tired of people quoting back my '83 book when they ought to read the '85 book and see how we've treated -- '95, sorry. A lot's happened in 12 years, a lot of growth. And the result of that is the kind of charges made back then are factually in error today, and I would hope that McIntyre, Member Mfume and others would start reading the '95 book and not the '83 book. Thank you very much.

Senator Mack. Does anyone else want to address the issue? Go ahead.

Mr. Kotlikoff. I want to say that first of all the standard distribution tables as I understand it are looking at taxes relative to income, which is current income.

Now, most economists think that consumption is really the more appropriate reference point for considering tax progressivity. A flat tax, really, by definition, is a proportional tax on consumption and consumption is being financed then out of wages and wealth. So it is really a proportional tax on wages and wealth.

Congress needs to consider more than one kind of distribution table. It needs to look at consumption as the reference point and think about taxes relative to consumption.

If you have a millionaire who is just paying taxes on capital income but not on his principal, it could well be that his tax payments under the income tax are quite low relative to those under a consumption that, so the current income tax, when referenced relative to consumption, is actually regressive. So when you go to a consumption tax, you go from a regressive income tax to a proportional tax, a proportional consumption tax.

We need that kind of status quo methodology which is to reference everything to current income is not necessarily the appropriate thing to do. Certainly it is not the sole thing you should look at and it is certainly not what the economics profession, I think, as a whole, would advise doing.

Senator Mack. That consumption is or is not?

Mr. Kotlikoff. Is the proper reference point, because it is really measuring living standard and so you look at taxes as a fraction of consumption.

Senator Mack. Mr. Rahn.

Mr. Rahn. In the debate about fairness, I am always struck that people who keep bringing this out seem to think that envy is a virtue rather than a sin. As far as I know, all the world's major religions look at envy as a sin.

But on the practical aspect, we look at the changes in the Tax Code over the last 25 or 30 years, there has been massive changes up and down, sideways and every which way. You take a look at the amount that comes into the Federal Treasury. It has always ranged between

18.5 and 19.5 percent of GDP; it's been constant regardless of what you folks have done up here all those years.

Why? Because we know that people will not pay taxes they perceive as unfair. They are going to find legal or illegal ways of getting around it.

The Tax Code, Senator Bennett, surely is not fair in its present situation. Nobody understands it, it is open to selective prosecution, even the IRS commissioners in recent years admitted there are all kinds of abuses going on in the IRS. People are considered guilty. They have to prove themselves innocent. It just flips American justice on its head. That surely isn't fair.

Is it fair to take people's income when it is spent unwisely by the Congress? Is that fair? We can go on and on and on about this but we know if we reduce the size of government as a part of our gross domestic product, then many of these problems begin to go away. You can come up with a much simpler type of tax system where people don't look at the government expropriating things they have worked hard to develop and accumulate over the years. I think the focus again has to be on growth, as I think virtually all responsible and serious economists now realize, and business people most certainly, that we have too much regulation, that we have just too much government and too much taxation for our own good and it is the people at the bottom end of the scale, the young people, who suffer most of all from this.

Senator Mack. Mr. McIntyre, let me get you back into this conversation.

Let's pick up on the point of growth. I would assume that you just approached this from a different perspective with respect to -- I have just been informed we only have a few minutes left, 11 minutes left on our vote so we are going to have to get out of here.

Mr. McIntyre. Let me be very brief, Mr. Chairman. I think there was some confusion, perhaps I was talking too quickly, about my views about Ronald Reagan's tax policies. You heard Jack Kemp say he was very proud of the 1981 Tax Act and he was sorry that he voted for the '86 bill. My position is the opposite.

Senator Mack. I don't think that is what he said.

Mr. McIntyre. I have a quote from him. He said about the '86 Tax Reform Act, "for which I will never forgive myself for being a partner to."

Senator Mack. He was referring to a specific part having to do with the capital gains tax rate. And, again, I just would say to you it's important.

Mr. McIntyre. That was one of the central provisions of the '86 Act!

Senator Mack. Mr. McIntyre, look, it is very important that the information you provide us be accurate. Secretary Kemp was focusing in on one aspect of it. To say that he would have voted against it --

Mr. McIntyre. Mr. Chairman, let me also say that Secretary Kemp led the charge in the House of Representatives to defeat the rule on the '86 Tax Reform Act. I know it well because it happened on my birthday, December 11, 1985. So he was against the bill generally and I understand why. He agreed, he believed --

Senator Mack. Mr. McIntyre, I wanted to ask you a question.

Mr. McIntyre. My point is this, Mr. Chairman --

Senator Mack. We are going to conclude the hearings.

Thank you.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

PREPARED STATEMENT OF SENATOR CONNIE MACK

We are here today to examine one of our nation's most critical issues, one that will impact the prosperity of every American. That issue is tax reform and its impact on economic growth. While numerous tax reform ideas have been suggested in recent months, our focus today will be on the economic growth potential of a flat tax system pioneered by Professors Robert Hall and Alvin Rabushka of Stanford University.

There is a large and growing consensus among economists, lawmakers, and typical taxpayers that our current income tax system has become a tremendous obstacle to economic growth and our standard of living. After eight decades of misuse by lawmakers, lobbyists, and special interests, our tax system is unfair, complex, costly, and punishes work effort, savings and in-vestment. Simply stated, our onerous income tax system is unfit to carry us into the 21st Century and prevents us from insuring a better future for our-selves, our children and grandchildren.

Since its 1913 enactment, our income tax system has fallen prey to a multitude of unintended purposes -- including income redistribution, social engineering, and government micro-management of our saving, investing, and spending decisions. As a result, our tax system treats individuals unfairly, extracts tremendous administration and compliance costs, and hinders the full productive potential of our economy. Sadly, our current income tax system hinders every American's potential for a higher standard of living.

Therefore, we need to fundamentally rethink the manner in which income is taxed in order to construct a system that is equitable, efficient, and can support economic growth. In order to achieve genuine tax reform, the blinders must be taken off, special interests must give way to the overriding national concerns, the politically motivated "rich versus poor" class warfare must stop, and the defenders of the status quo must make way for positive change. Tax tinkering, or simply reshuffling the existing tax burden is not genuine tax reform. We must create a new tax structure that allows everyone to benefit from economic growth while at the same time preventing the anti-growth tax system we have now from ever re-emerging.

The flat tax encompasses this new thinking and fundamental change needed to create a fair, simple, and pro-growth tax system.

While the flat tax would help correct the inequities and complexity in our current tax system, I believe the most important reason to undertake any tax reform is to improve our standard of living. If tax reform fosters just a 0.5% increase in GDP growth, the typical American family after 5 years would have incomes more than $3,000 higher then they would be under current tax law. The most important benefit the flat tax could offer all Americans is unparalleled economic growth.

The flat tax is such a fundamental change from the way government does business today that there are no economic models which can fully calculate its impact on economic growth. Nobody -- not CBO, not OMB, not the Treasury Department, nor the Joint Committee on Taxation -- has predicted the dynamic potential of the flat tax.

As Chairman of the Joint Economic Committee, I have called this hearing to examine the potential effects of the flat tax on individual behavior, corporate behavior, and the economy in general. In short, the information we need to make an informed decision.

No doubt, the typical static income distribution and revenue models used to trumpet the so-called tax "winners" and "losers" will be used in an attempt to scare us into preserving the status quo. However, these models cannot encompass the real essence of the flat tax -- its potential to make everyone better off through economic growth and increase incomes across all classes. Any static comparison of what one pays in taxes today to what they will pay under the flat tax system simply fails to capture many important aspects of the flat tax. For example:

Will families be better off under a tax reform that lowers interest rates on mortgages, credit cards, and auto loans?

Will consumers be better off with a tax reform that reduces inflation?

Will families be better off under a tax system that would now allow a spouse to enter the work force or get a raise without pushing the family into a higher tax bracket?

Would families be better off under a tax system that would let them save and Invest for their future without punishing these decisions with high tax rates and double taxation?

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We know static analysis has been proven wrong time and time again. A flat tax that eliminates destructively high marginal tax rates would boost investment, productivity, wage-growth, and the standard of living. And, the Treasury would see an increase in revenues. This is not idle speculation. When Presidents Kennedy and Reagan lowered marginal tax rates, the economy boomed. We didn't need static models to discover this economic growth potential.

Today, the graduated income tax system garners an increasing share of people's hard work and success. It's no wonder Americans feel they are working longer and harder with nothing to show for it -- they are!

For 82 years, the tax code has grown to accommodate the demands of special interest groups. It's now time for a tax system that addresses the economic concerns of the typical taxpaying individual and family.

I look forward to hearing the testimony from our impressive line-up of expert witnesses joining us here today.

Testimony of Senator Arlen Specter

Joint Economic Committee
Flat Tax Hearing
May 17, 1995

Mr. Chairman, I appreciate the opportunity to appear before the Senate and House Joint Economic Committee to testify on an issue of paramount importance to all Americans -- economic growth -- and to detail my blueprint for achieving that growth by restructuring our nation's tax code.

The tax system that we use in America today is a national disgrace, with a dedicated deduction for every interest group and a loophole for every lobbyist. Our current system is bizarre, burdensome, and biased against growth. The flat tax will give the American people a system which is simple, fair and pro-growth.

My bill, the Flat Tax Act of 1995 (S.488), would scrap the vast majority of IRS rules and regulations, with the myriad rates, deductions and instructions, and replace them with a 20% flat tax under which Americans could file their tax returns on a simple 10-line postcard. Thus, instead of spending billions of dollars every year on high-priced tax attorneys or accountants who are a virtual necessity for anyone seeking to fill out tax returns, and billions of hours, Americans could devote their energies to more productive pursuits.

The basic model for my legislation comes from a plan created by Professors Robert Hall and Alvin Rabushka of the Hoover Institute and a flat tax bill introduced in the House of Representatives by Majority Leader Richard Armey. These other plans, however, would eliminate all deductions.

I have included limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. While these modifications limit the purity of the flat tax principle, I believe that those two deductions are so deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness -- and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult; but without them, probably impossible.

In this Congress, we have been concerned with the work of reducing the size and cost of government, and this is work which is vitally important. But the work of downsizing government is only one side of the coin. What we must do at the same time, and with as much energy and care, is to promote economic growth. As we reform the welfare programs and government bureaucracies of past administrations, we must replace those programs with a prosperity that extends to all segments of American society through private investment and job creation -- which can have the additional benefit of producing even lower taxes for Americans as economic expansion adds to federal revenues. Just as Americans need a tax code that is fair and simple, they also are entitled to tax laws designed to foster rather than retard economic growth.

Under my tax plan, individuals would be taxed at a flat rate of 20% on all income they earn from wages, pensions and salaries. Individuals would not be taxed on any capital gains, interest on savings, or dividends. The flat tax will also eliminate all but two of the deductions and exemptions currently contained within the tax code. Instead, taxpayers will be entitled to "personal allowances" for themselves and their children: $9,500 for a single taxpayer, $14,000 for a single head of household and $16,500 for a married couple filing jointly; and $4,500 per child or dependent. These personal allowances would be adjusted annually for inflation. Thus, a family of four would be entitled to $25,500 in tax-free income before any taxes were assessed on their wages.

Businesses would also be taxed at a flat rate of 20%. My legislation would eliminate the intricate scheme of depreciation schedules, deductions, credits, and other complexities. Instead, businesses would only deduct wages, direct expenses and purchases. Businesses would be allowed to expense 100% of the cost of capital formation, including purchases of capital equipment, structures and land, and to do so in the year in which the investments are made.

The key advantages of this flat tax plan are three-fold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts, and as interest rates drop. By contrast, there will be a contraction of the IRS if this proposal is enacted.

Simplicity

The first major advantage to this flat tax is simplicity. According to reliable studies, Americans spend approximately 5.4 billion hours each year filling out tax forms. Much of this time is spent burrowing through IRS laws and regulations, which, according to the Tax Foundation, have grown from 744,000 words in 1955 to 5.6 million words in 1994. Even those IRS forms which are intended to be simple are not. The IRS notes proudly that it should take taxpayers "only" 2 hours and 54 minutes to complete and file the 1040EZ form, which is supposedly the most simple tax form available.

Whenever the government gets involved in any aspect of our lives, it can convert the most simple goal or task into a tangled array of complexity, frustration and inefficiency. By way of example, most Americans have become familiar with the absurdities of the government's military procurement programs. If these programs have taught us anything, it is how a simple purchase order for a hammer or a toilet seat can mushroom into thousands of words of regulations and restrictions when the government gets involved. The Internal Revenue Service is certainly no exception. Indeed, it has become a distressingly common experience for taxpayers to receive computerized print-outs claiming that additional taxes are due, which require repeated exchanges of correspondence or personal visits before it is determined, as it so often is, that the taxpayer was right in the first place.

My plan would eliminate these kinds of frustrations for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete literally millions of words from the Internal Revenue Code. Instead of billions of hours of non-productive time spent in compliance with (or avoidance of) the tax code, taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

The flat tax I have proposed can be calculated just by filling out a small postcard which requires a taxpayer only to answer a few easy questions. The postcard would look like this:

Form 1 — **Individual Wage Tax** — **1995**

Your first name and initial (if joint return, also give spouse's name and initial)	Your social security number - -
Home address (number and street including apartment number or rural route)	Spouse's social security number - -
City, town, or post office, state, and ZIP code	

1. Wages, salary, pension and retirement benefits — 1______
2. Personal allowance (enter only one)
   -- $16,500 for married filing jointly
   -- $9,500 for single
   -- $14,000 for single head of household — 2______
3. Number of dependents, not including spouse, multiplied by $4500 — 3______
4. Mortgage interest on debt up to $100,000 for owner-occupied home — 4______
5. Cash or equivalent charitable contributions (up to $2,500) — 5______
6. Total allowances and deductions (lines 2, 3, 4 and 5) — 6______
7. Taxable compensation (line 1 less line 6, if positive; otherwise zero) — 7______
8. Tax (20% of line 7) — 8______
9. Tax withheld by employer — 9______
10. Tax or refund due (difference between lines 8 and 9) — 10______

Filing a tax return would become a manageable chore, not a seemingly endless nightmare, for most taxpayers.

Slash the IRS

Along with the advantage of simplicity, enactment of this flat tax bill will help to remove the burden of costly and unnecessary government regulation, bureaucracy and red tape from our everyday lives. The heavy hand of government bureaucracy is particularly onerous in the case of the Internal Revenue Service, which has been able to extend its influence into so many aspects of our lives.

In 1994, the IRS employed over 110,000 people, spread out over 650 offices across the United States. Its budget was in excess of $13 billion, with some $7.1 billion spent annually just to administer the tax laws, and another $4 billion for enforcement. By simplifying the tax code and eliminating most of the IRS' vast array of rules and regulations, the flat tax would enable us to cut a significant portion of the IRS budget, including the bulk of the funding now needed for enforcement and administration.

In addition, a flat tax would allow taxpayers to redirect their time, energies and money away from the yearly morass of tax compliance. According to the Tax Foundation, in 1994, businesses spent approximately $127 billion in compliance with the federal tax laws, and individuals spent an additional $65 billion, for a total of $192 billion. Monies spent by businesses and investors in creating tax shelters and finding loopholes could be instead directed to productive and job-creating economic activity. With the adoption of a flat tax, the opportunities for fraud and cheating would also be vastly reduced, allowing the government to collect, according to some estimates, over $120 billion annually.

Economic Growth

Another major advantage to a flat tax is that it will be a tremendous spur to economic growth. Because of the incentives for savings and investment contained in my legislation, economists estimate that interest rates would fall by as much as two points and the economy would grow by up to $2 trillion, in present value terms, over a seven year period. That represents an increase of $1,900 in wealth for every man, woman and child in America.

The economic principles are fairly straightforward. Our current tax system is inefficient; it is biased toward too little savings and too much consumption. The flat tax creates substantial incentives for savings and investment by eliminating taxation on interest, dividends and capital gains -- and tax policies which promote capital formation and investment are the best vehicle for creation of new and high paying jobs, and for a greater prosperity for all Americans.

It is well recognized that to promote future economic growth, we need not only to eliminate the federal government's reliance on deficits and borrowed money, but to restore and expand the base of private savings and investment that has been the real engine driving American prosperity throughout our history. These concepts are interrelated, for the federal budget deficit soaks up much of what we have saved, leaving less for businesses to borrow for investments.

It is the sum total of savings by all aspects of the U.S. economy that represents the pool of all capital available for investment -- in training, education, research, machinery, physical plant, etc. -- and that constitutes the real seed of future prosperity. The statistics here are daunting. In the 1960s, the net U.S. national savings rate was 8.2 percent, but it has fallen to a dismal 1.5 percent. In recent international comparisons, the U.S. has the lowest savings rate of any of the G-7 countries. We save at only one-tenth the rate of the Japanese, and only one-fifth the rate of the Germans, which is clearly reflected in the comparative growth rates of our economies over the last three decades.

An analysis of the components of U.S. savings patterns shows that although the federal budget deficit is the largest cause of "dissavings," both personal and business savings rates have declined significantly over the past three decades. Thus, to recreate the pool of capital stock that is critical to future U.S. growth and prosperity, we have to do more than just get rid of the deficit. We have to very materially raise our levels of private savings and investment. And we have to do so in a way that will not cause additional deficits.

The less money people save, the less money is available for business investment and growth. The current tax system discourages savings and investment, because it taxes the interest we earn from our savings accounts, the dividends we receive from investing in the stock market, and the capital gains we earn from successful investments in our homes and the financial markets. Indeed, under the current law these rewards for saving and investment are not only taxed, they are overtaxed -- since gains due solely to inflation, which represent no real increase in value, are taxed as if they were really profit.

With the limited exceptions of retirement plans and tax free municipal bonds, our current tax code does virtually nothing to encourage personal savings and investment, or to reward it over consumption. As William Schreyer wrote recently in the Harvard Business Review, "the budget deficit is only one part of a larger national problem: the U.S. saving deficit."

S.488 will change this system, and address this problem. The proposed legislation reverses the current skewed incentives by promoting savings and investment by individuals and by businesses. Individuals would be able to invest and save their money tax-free and reap the benefits of the accumulated value of those investments without paying a capital gains tax upon the sale of these investments. Businesses would also invest more as the flat tax allowed them to expense fully all sums invested in new equipment and technology in the year the expense was incurred, rather than dragging out the tax benefits for these investments through complicated depreciation schedules. With greater investment and a larger pool of savings available, interest rates and the costs of investment would also drop, spurring even further economic growth.

Critics of the flat tax have argued that we cannot afford the revenue losses associated with the tremendous savings and investment incentives the bill affords to businesses and individuals. Those critics are wrong . Not only is this bill intended to be revenue neutral, but historically we have seen that when taxes are cut, revenues actually increase, as more taxpayers work harder for a larger share of their take-home pay, and investors are more willing to take risks in pursuit of rewards that will not get eaten up in taxes. As one example, under President Kennedy individual tax rates were lowered, investment incentives including the investment tax credit were created and then expanded, depreciation rates were accelerated, and yet between 1962 and 1967 gross annual federal tax receipts went from $99.7 billion to $148 billion -- an increase of nearly 50%. More recently under President Reagan, after his tax cuts in the early 1980's, government tax revenues rose from just under $600 billion in 1981 to nearly $1 trillion in 1989. In fact, the Reagan tax cut program helped to bring about the longest peacetime expansion of the U.S. economy in history. There is every reason to believe that the flat tax proposed here can do far more -- and by maintaining revenue neutrality in this flat tax proposal, as we have, we can avoid any increases in annual deficits and the national debt.

As Professors Hall and Rabushka state it, the growth case for a flat tax is compelling. It is even more compelling in the case of a tax revision that is simple and demonstrably fair.

Fairness

In addition to increasing federal revenues by fostering economic growth, the flat tax can also add to federal revenues without increasing taxes by closing tax loopholes. Personal income in the United States totals about $5 trillion. Of this amount, however, only $2.4 trillion is reported as taxable income. Thus, over 50% of personal income is sheltered by legal loopholes, deductions, credits, exemptions or outright fraud. Under a flat tax system, all tax shelters will disappear and all income will be subject to taxation. With a broader tax base, we can then lower tax rates and ensure that all Americans pay their fair share of taxes.

The flat tax also promotes fairness by lessening the tax burden on working families. By eliminating loopholes and thus broadening the tax base, my legislation will force many higher income taxpayers to pay their fair share of taxes -- and it will allow us to lower the taxes paid by lower and middle income families.

Mr. Chairman, no one likes to pay taxes, and no one likes the billions of dollars in additional hidden taxes and costs they incur every year simply seeking to comprehend and comply with the tax code. My 20% Flat Tax Act will dramatically restructure the IRS by eliminating most of its rules and regulations and firing most of its employees, and, as a result, it will change the way Americans feel about the tax code. I believe that all Americans would be willing to pay their share of taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My 20% flat tax bill affords Americans such a tax system.

In sum, I believe the flat tax is an idea whose time has come. Whether it is my bill or some other legislation, I urge this Committee to support bringing flat tax legislation to the floor of the Senate at the earliest possible moment. And I look forward to working with you in this endeavor.

Thank you Mr. Chairman and members of the Committee.

ADVANTAGES TO FLAT TAX PLAN

* SIMPLICITY	A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.4 billion hours they currently spend every year in tax compliance.
* CUTS GOVERNMENT	The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which take up 12,000 pages, and have grown from 744,000 words in 1955 to 5.6 million words in 1994. It would also allow us to slash the mammoth IRS bureaucracy of 110,000 employees spread out over 650 offices nationwide.
* PROMOTES ECONOMIC GROWTH	Economists estimate a growth of over $2 trillion in national wealth over seven years, representing an increase of $1900 in personal income for every man, woman and child in America.
* INCREASES EFFICIENCY	Investment decisions would be made on the basis of productivity rather than simply for tax avoidance, thus leading to even greater economic expansion.
* REDUCES INTEREST RATES	Economic forecasts indicate that interest rates would fall substantially, by as much as two points, as the flat tax removes many of the current disincentives to savings.
* LOWERS COMPLIANCE COSTS	Americans would be able to save up to $192 billion they currently spend every year in tax compliance.
* DECREASES FRAUD	As tax loopholes are eliminated and the tax code is simplified, there will be far less opportunity for tax avoidance and fraud, which now amounts to over $120 billion in uncollected revenue annually.
* REDUCES IRS COSTS	Simplification of the tax code will allow us to save significantly on the $13 billion annual budget currently allocated to the Internal Revenue Service.

PREPARED STATEMENT OF REPRESENTATIVE DICK ARMEY

I want to begin by expressing my deep appreciation to you Mr. Chairman for holding this hearing today on the economic growth effects of replacing today's arcane tax system with a flat tax. While the flat tax has struck a responsive chord in America because of its inherent fairness, I also believe that the American people appreciate the fact that a flat tax would improve the incentives to work, save, and invest, and raise living standards.

There's no question the American people genuinely loathe the current system. Talk to any person on the street, any audience, or review any public opinion poll and you find the income tax is regarded as patently unfair, inordinately complex, and adverse to economic growth. The American people believe correctly that we could hardly do worse than today's income tax system.

Current System Reduces Wages

Let's begin with the sheer waste associated with unnecessary compliance costs due to the complexity of the income tax. The compliance burden of our complex tax code is truly mind boggling. Americans spend 5.4 billion man hours figuring out the tax law. That is the equivalent of nearly three million people working full time, year round. The Internal Revenue Service sends out eight billion pages of forms and instructions every year, which if you laid them end to end, would stretch 28 times the circumference of the earth. Just the compliance cost of today's tax code adds up to $232 billion, according to James L. Payne.

The code is complex because of the endless credits, deductions, and loop-holes designed to grant special preferences. These biases throughout the tax code distort economic decisions and divert resources from their most productive use, thus placing a heavy toll on economic output, wages and living standards.

The code is so complicated that even IRS agents cannot give accurate advice on it. Rates are high, loopholes abound, and noncompliance is rife because taxpayers feel the code it written not for them, but for well-organized special interests. And perhaps most disturbing, the complexity and unfairness of the code lead people to take an excessively jaded and cynical view of their government.

But the current tax code does much more than impose staggering compliance costs and efficiency losses. Perhaps the worst feature of today's code is the discriminatory treatment of savings. Consider how the present tax code treats saving and investment. Today, we double tax business earnings, which places a strong bias against saving and investment. For example, we tax business earnings through the corporate income tax and then we tax dividends -- which are, in fact, after-tax payments. This double taxation of the same stream of income makes saving and investing much less attractive relative to consumption. And the nation is poorer as a result.

Mr. Chairman, capital is the lifeblood of an economy. Without capital, workers cannot enhance their productivity and their wages stagnate. Today's double and even triple taxation of income discourages saving, reduces the pool of capital available to entrepreneurs and workers, slows productivity and wage growth, lowers living standards, and, as a side effect, reduces revenue to the Treasury. I believe we must fix this counterproductive policy. As I shall explain momentarily, my flat tax is designed to do just that.

Another problem with today's tax code is its high marginal rates. Any professional economist will tell you that as marginal tax rates rise, people tend to work less. The higher the marginal rate, the lower the work effort. Where only the very wealthy faced high marginal tax rates a few decades ago, today millions of Americans do. According to IRS data, in 1965, fewer than three percent of families filing joint returns faced a federal marginal tax rate of 28 percent or more. In 1991, 36 percent of families -- more than ten times as many -- filing joint returns faced these high marginal rates. With state and local income taxes included, millions of middle class Americans confront a combined marginal tax rate of 48 percent.

Naturally, many Americans ask themselves why they should work longer hours when the government is going to take away half of their earnings. A study by Robert Genetski has found that high marginal tax rates are inversely related to productivity growth, which is to say, workers and entrepreneurs spend less time trying to build the proverbial "better mousetrap" when the government is going to take most of the rewards for doing so anyway. The net result, again, is a poorer nation.

While not a tax issue, I would be remiss if I did not also mention that the growth of federal regulations has also played a very important role in slowing labor productivity and wage growth -- a fact which is often over-looked. The geometric growth in federal red tape has reduced the return to investment, diverted resources from their most efficient use, raised the cost of labor, and sapped entrepreneurial energy. Federal regulations have had a particularly adverse effect on wage growth for two reasons. Higher payroll taxes and government mandates such as family leave directly raise the cost of labor and thus lower wages. Other regulations, such as environmental mandates, have indirectly lowered wages by diverting resources away from investment which would raise the productivity of labor.

How Will the Armey Flat Tax Work?

My plan, which is based on a 1981 proposal by Hoover Institution fellows Robert Hall and Alvin Rabushka, would scrap the existing tax code entirely. Instead, *all income would be taxed once and only once at the single low rate of 17 percent.* To minimize revenue loss, the rate would initially be set at 20 percent, then drop to 17 percent in year three. Income is defined as the total of wages, salary, and pensions. There would be no credits or deductions, although each taxpayer would receive a generous family allowance. Beginning in year three of the plan, this allowance, which is indexed for inflation, would be $13,100 for an individual, $26,200 for a married couple, and $5,300 for each child. A family of four would have to earn $36,800 before it owed a penny of federal income tax.

Business income would be handled with equal simplicity. A corporation would simply subtract expenses from revenues and pay 17 percent on the remainder. Revenues are defined as corporate, partnership, professional, farm, and rental income. The base is gross revenue less purchases of goods and services, capital equipment, structures, land, and wage and pension contributions to employees.

Flat Tax Promotes Economic Growth

The flat tax would produce a higher economic growth rate and raise living standards. It would liberate the economy to be more efficient, replacing today's maze of politically targeted tax breaks with a system that is perfectly neutral as between types and sizes of business, between economic sectors, and between types of investment. Resources would be allowed to seek out their most efficient use.

In other words, the flat tax would relieve the economy from what economists call "dead weight" or social welfare loss. As I noted earlier, just the compliance costs of today's tax code add up to $232 billion -- or about $900 for every American. When other costs of the current system -- such as tax distortions which shift resources away from their most efficient use, thus lowering output -- are included, the cost to the economy is well into the hundreds of billions of dollars.

These costs are pure waste and directly lower the standard of living of the American people. The flat tax would eliminate the vast majority of these costs and dramatically improve the performance of the economy.

The flat tax would also lower the burden currently placed on work, savings, and investment. It rewards *work* by lowering the top marginal income-tax rate from 40 percent to 17 percent. It rewards *saving* by ending the current taxation of savings, sweeping away the estate tax, the capital gains tax, and the double tax on interest and dividends. And it rewards *investment* by permitting businesses to immediately deduct all expenses, plant, and equipment. Thus, the flat tax would produce higher productivity and economic growth, leading to higher employment and wages.

What the Economists Say

Professor Dale Jorgenson estimates that the loss in efficiency imposed on the economy by the current tax system equals 18 percent of government revenue. As he puts it, "Each dollar of tax revenue costs the private sector a dollar in foregone investment or consumption and an additional loss in growth opportunities of eighteen cents." In other words, the distortions in the current income tax code cost the American economy $242 billion in lost output. If we replaced the current system with a nondistortive one, that alone would be the equivalent of writing every American a check for nearly $1,000 every year.

By taxing all income only once, the neutral treatment of savings would create a powerful new incentive to save and invest. Professors Alan Auerbach and Larry Kotlikoff estimate that just ending the double taxation of savings would increase the growth rate in the economy by nearly a percentage point. While that may seem trivial, a one percentage point increase in economic growth would add $65 billion to the national output this year.

By lowering marginal tax rates, the bill would unleash the creative energies of America's entrepreneurs and workers. After reviewing the economic literature, Hoover fellows Hall and Rabushka estimate in their book, *The Flat Tax,* that work effort would increase four percent. I believe Professor Kotlikoff, who will appear later today with Professor Rabushka, has a similar estimate. That translates into a 3 percent increase in output or nearly $750 in additional income for each American.

When adding the effects of more work effort, a higher capital stock, and improved incentives for entrepreneurial effort, Professors Hall and Rabushka estimate that a flat tax would increase per capita income by $1,900 by the year 2002. In other words, a typical family of four in America would see its income increase $7,600 more than if we preserve the tax system we have today. Let me emphasize that while this is a truly astonishing number, it is based on the consensus of the economic literature and is a mainstream estimate. Many studies suggest the number would be even higher.

Americans Want the Flat Tax

For those who are suspicious of economic models and the figures which economists generate from them, let me share an observation. Last year when campaigning for the candidates who would be come the new Republican majority, I stopped in Washington State. At one of the events there, the speaker related how several small businessmen and women had decided, because of high taxes and burdensome regulations, to let all of their employees go. I have heard similar stories from people who decided against starting a business at all because of high, complex taxes and red tape. I've heard countless other examples of small businessmen, often a husband and wife team, that refuse to expand their business and hire employees because of the hassle associated with it.

While we debate national economic policy based on GDP data and employment statistics, we often times overlook the fact that these statistics fail to account for the businesses not started and the jobs not created. The decisions people make not to start a business or not to hire employees will never show up in any Commerce or Labor Department data, but the economic loss is very real, nevertheless. Cumulatively they represent a national tragedy. The loss is millions of jobs never created, thousands of new businesses never initiated, billions in output never generated. And, incidentally, billions in taxes never sent to Washington.

Since introducing the flat tax, I have received thousands of letters from average Americans from across the entire nation. Many of these people explain in their letters how difficult the government makes it for them to run their businesses and make a living. Let me give you just two examples.

James and Nancy of Carabelle, Florida write, "Because of government regulations, and complicated laws regarding employees, withholding, payroll, etc., we have continuously avoided hiring people in favor of keeping small and simple. I know a lot of intelligent people who feel and do likewise. It's a shame that our laws/lawmakers continue to pile-it-on business, killing the entrepreneurial spirit within so many of us. We strongly support the Dick Armey flat tax proposal and all of its features. Let's make an indelible mark on the future of this country!"

Then there is John from Evergreen, Colorado. He writes, "I once started with $1,500, a second-hand kitchen table, and a donated typewriter and --in ten years -- built a $20,000,000 a-year business. But I walked away from all that about 14 years ago...too many taxes, too many rules and regulations, too many bureaucrats. Get your plan passed intact and hundreds of thousands of people like me will come out of the woodwork and create a prosperity that the world only sees now in some Asian countries!"

The flat tax plan I have proposed, together with the spending restraint and regulatory relief included in my bill, will free the economy and encourage the American people to work hard, save, invest, create jobs and grow the economy. The flat tax would tap the latent entrepreneurial energy and talent that is now smothered by the invisible foot of government.

Thank you.

INTRODUCTIONS SUBMITTED BY SENATOR CONNIE MACK

MR. ALVIN RABUSHKA is a senior fellow at the Hoover Institution at Stan-ford University where he specializes in the public policy areas of taxation, constitutional limitations on taxing and spending, and economic development.

He has championed the Flat Tax reform that we are here debating today. MR. RABUSHKA appeared before this Committee for the first Congressional hearings ever held on the flat tax.

MR. RABUSHKA received his A.B. in Far Eastern studies from Washington University in Saint Louis, followed by his M.A. and PH.D. degrees in political science from Washington University.

He is the author and co-author of numerous books in the areas of race, ethnicity, aging, taxation, state and local government finances, and Israel's economy.

ROBERT McINTYRE directs Citizens for Tax Justice -- a coalition of labor, public interest and citizens groups that fights for tax reform.

Before joining Citizens for Tax Justice in 1980, MR. McINTYRE was the director of Public Citizen's Tax Reform Research Group.

MR. McINTYRE frequently writes about taxes for publications such as *The New Republic*, *The Atlantic*, *The New York Times*, *The Washington Post* and *The Los Angeles Times*.

A graduate of the University of Pennsylvania Law School and Providence College, MR. McINTYRE served on the Advisory Group to the Commissioner of Internal Revenue and often advises government officials on tax policy, both informally and in written testimony.

MR. McINTYRE and his wife Nancy have two children.

RICHARD RAHN is president and chief executive officer of Novecon Ltd. and Novecon Management Co., L.P. He also serves as Chairman of the Board of Directors of the Business Leadership Council, a free market business association.

DR. RAHN has also held the positions of vice president and chief economist of the United States Chamber of Commerce, executive vice president and a member of the Board of the National Chamber Foundation, and editor-in-chief of the *Journal of Economic Growth*.

DR. RAHN earned his B.A. in economics at the University of South Florida, an M.B.A. from Florida State University, and a PH.D. in business economics from Columbia University.

A frequent commentator on shows such as the Today Show, Good Morning America, Wall Street Week, Newshour, and Crossfire, Dr. Rahn has published more than 100 articles in newspapers, magazines and professional journals. He has also testified before Congress more than 75 times.

LAURENCE KOTLIKOFF is Professor of Economics at Boston University, a Research Associate of the National Bureau of Economic Research, and Fellow of the Econometric Society.

Prior to joining Boston University, Mr. Kotlikoff has served as a senior economist with the President's Council of Economic Advisors from 1981-82, and as a consultant to the International Monetary Fund, the World Bank, the Organization for Economic Cooperation and Development and the Joint Committee on Taxation to name a few.

MR. KOTLIKOFF has often provided expert testimony on various occasions to committees of Congress including the Senate Finance Committee and the House Ways and Means Committee.

MR. KOTLIKOFF received his B.A. in Economics from the University of Pennsylvania and his PH.D. in Economics from Harvard University.

He has published extensively in professional journals, newspapers and magazines on issues of deficits, the tax structure, pensions and insurance.

The Flat Tax and the Economy

Testimony Prepared for the Joint Economic Committee
May 17, 1995

Alvin Rabushka and Robert E. Hall

Tax reform along the lines of a sample flat tax, set forth in Chapter 3 of our book, *The Flat Tax, 2d Edition* (Stanford: Hoover Press, 1995), and which provides the intellectual foundations for the flat tax plans introduced by Rep. Dick Armey and Senator Arlen Specter, among others, will influence the American economy profoundly. Improved incentives for work, entrepreneurial activity and capital formation will substantially raise national output and the standard of living.

STIMULUS TO GROWTH

The flat tax at a low, uniform rate of 19 percent will improve the performance of the U.S. economy. Improved incentive to work through increased take-home wages will stimulate work effort and raise total output. Rational investment incentives will raise the overall level of investment and channel it into the most productive areas. And sharply lower taxation of entrepreneurial effort will enhance this most critical input to the economy.

Work Effort

About two thirds of taxpayers today enjoy the low income tax rate of 15 percent enacted in 1986. Under the flat tax, over half of these taxpayers would face zero tax rates because their total family earnings would fall short of the exemption amount ($25,500 for a family of four). The others in this group would face a slight increase in their tax rate on the margin, from 15 percent to 19 percent. The remaining third of taxpayers in 1991 were taxed at rates of 28 and 31 percent, much higher than the flat rate of 19 percent. And the addition of the 39.6 percent bracket in 1993 worsened incentives further. Heavily taxed people earn a disproportionate share of income: In 1991, 58 percent of all earnings were taxed at rates of 28 percent or higher. The net effect of the flat tax with marginal rates of zero and 19 percent would be a dramatic improvement of incentives for almost everyone who is economically active.

One point we need to get straight at the very start is that a family's marginal tax rate determines its incentives for all types of economic activity. There is much confusion on this point. For example, some authors have written that married women face a special disincentive because the marginal tax on the first dollar of her earnings is the same as the marginal tax on the last dollar of her husband's earnings. It is true that incentives to work for a woman with a well-paid husband are seriously eroded by high tax rates. But so are her husband's incentives. What matters for both of their decisions is how much of any extra dollar of earnings they will keep after taxes. Under the U.S.

income tax, with joint filing, the fraction either of them takes home after taxes is always the same, no matter how their earnings are split between them.

Sheer hours of work make up one of the most important dimensions of productive effort, and one that is known to be sensitive to incentives. At first, it may seem difficult for people to alter the amount of work they supply to the economy. Aren't most jobs 40 hours a week, 52 weeks a year? It turns out that only a fraction of the work force is restricted in that way. Most of us face genuine decisions about how much to work. Teenagers and young adults—in effect anyone before the responsibilities of parenthood—typically work much less than full time for the full year. Improving their incentives could easily make them switch from part-time to full-time work or cause them to spend less time taking it easy between jobs.

Married women remain one of the largest underutilized resources in the U.S. economy, although a growing fraction enters the labor market each year. In 1993, only 58 percent of all women over 15 were at work or looking for work; the remaining 42 percent were spending their time at home or in school, but could be drawn into the market if the incentives were right. There is simply no doubt about the sensitivity of married women to economic incentives. Every study has shown a systematic tendency for women with low after-tax wages and high incomes from their husbands to work very little. Those with high after-tax wages and lower incomes work a lot. It is an altogether reasonable inference that sharply reduced marginal tax rates on married women's earnings will further stimulate their interest in the market.

Another remarkable source of unused labor power in the United States is men who have taken early retirement. Although 92 percent of men aged 25 to 54 are in the labor force, only 65 percent of those from 55 to 64 are at work or looking for work—just 17 percent of those over 65. Again, retirement is very much a matter of incentives. High marginal taxation of earnings discourages many perfectly fit men from continuing to work. Because mature men are among the best paid in the economy, a great many of them face marginal tax rates of 28, 36 or even 40 percent. Reduction to a uniform 19 percent could significantly reduce early retirement and make better use of the skills of older men.

A great deal of effort by economists has been devoted to measuring the potential stimulus to work effort from tax reform. The consensus from this body of research is that all groups of workers would respond to the flat tax by raising their work effort. A few workers would reduce their hours, either because the flat rate would exceed their current marginal rate or because the reform would add so much to their incomes that they would feel that earning was less urgent. But the great majority would face much improved incentives. The smallest responses are found for adult men and the largest for married women.

For the switch from the current tax law to our proposed flat tax, a reasonable projection, in the light of the research on labor supply, is an increase of about 4 percent in total hours of work in the U.S. economy. The increase of 4 percent would be about 1.5 hours per week on the average, but would take the form of second jobs for some workers, more weeks of work per year for others, as well as more hours per week for those working part time. The total annual output of goods and services in the U.S. economy would rise by about 3 percent, or almost $200 billion. That is nearly $750 per person, an astonishing sum. Of course, it might take some time for the full influence of improved incentives to have their effect. But the bottom line is unambiguous: tax reform would have an important favorable effect on total work effort.

Capital Formation

Economists are far from agreement on the impact of tax reform on investment. As we have stressed earlier, the existing system puts heavy tax rates on business income, even though the net revenue from the system is small. These rates seriously erode investment incentives. Erratic investment provisions in the current law and lax enforcement of taxes on business income at the personal level, however, combine to limit the adverse impact. The current tax system subsidizes investment through tax-favored entities such as pension funds, while it taxes capital formation heavily if it takes the form of new businesses. The result has been to sustain capital formation at reasonably high levels but to channel the investment into inefficient uses.

The most important structural bias of the existing system is the double taxation of business income earned in corporations and paid out to shareholders. Double taxation dramatically reduces the incentive to create new businesses in risky lines where debt financing is not available. On the other side, the existing system places no current tax on investments that can be financed by debt and where the debt is held by pension funds or other nontaxed entities. The result is a huge twist in incentives, away from entrepreneurial activites and toward safe, debt-financed activities.

The flat tax would eliminate the harmful twist in the current tax system. The flat tax has a single, uniform incentive for investment of all types—businesses would treat all purchases of capital equipment and buildings as expenses. As we noted in the description of our plan in Chapter 3, allowing immediate write-off of investment is the ideal investment incentive. A tax system that taxes all income evenly and allows expensing of investment is a tax on consumption. Two leading public finance economists, Alan Auerbach and Laurence Kotlikoff, estimated that the use of a flat-rate consumption tax in place of an income tax would raise the ratio of capital stock to GDP from 5.0 to 6.2. Other economists are less optimistic that the correction of the double taxation of saving would provide the resources for this large an increase in investment. But all would agree that there would be *some* favorable effect on capital formation.

In terms of added GDP, the increase in the capital stock projected by Auerbach and Kotlikoff would translate into 6 percent more goods and services. Not all of this extra growth would occur within the seven-year span we are looking at. But, even allowing for only partial attainment in seven years and for a possible overstatement in their work, it seems reasonable to predict a 2 to 4 percent increase in GDP on account of added capital formation within seven years.

Tax reform would improve the productivity of capital by directing investment to the most productive uses. Auerbach has demonstrated, in a paper published by the Brookings Institution, that the bias of the current tax system toward equipment and away from structures imposes a small but important burden on the economy. The flat tax would correct this bias. Auerbach estimates that the correction would be equivalent to a 3.2 percent increase in the capital stock. GNP would rise on this account by 0.8 percent.

Entrepreneurial Incentives and Effort

U.S. economic growth has slowed in the past decade, and surely one of the reasons is the confiscatory taxation of successful endeavors and the tax subsidy for safe, nonentrepreneurial undertakings. There aren't any scholarly studies with quantitative conclusions on the overall benefits from a fundamental shift, but they could be large.

Today's tax system punishes entrepreneurs. Part of the trouble comes from the interest deduction. The people in the driver's seat in the capital market, where money is loaned and borrowed, are those who lend out money on behalf of institutions and those individuals who have figured out how to avoid paying income tax on their interest. These people don't like insecure loans to new businesses based on great new ideas. They do like lending secured to readily marketable assets by mortgages or similar arrangements. It's easy to borrow from a pension fund to build an apartment building, buy a boxcar, put up a shopping center, or anything else where the fund can foreclose and sell the asset in case the borrower defaults. Funds won't lend money to entrepreneurs with new ideas, because they are unable to evaluate what they could sell off in case of a default.

Entrepreneurs can and do raise money the hard way, by giving equity interests to investors. An active venture-capital market operates for exactly this purpose. But the cost to the entrepreneur is high—the ownership given to the financial backers deprives the entrepreneur of the full gain in case things work out well.

So far we have just described the harsh reality of trying to get other people to put money into a risky, innovative business. Even with the best tax system, or no taxes at all, entrepreneurs would not be able to borrow with ordinary bonds or loans and thus capture the entire future profits of a new business. Equity participation by investors is a fact of life. But it is the perverse tax system that greatly worsens the incentives for entrepreneurs. The combination of corporate and personal taxation of equity investments actually is close to confiscation. The owners of a successful new business are taxed first when the profits flow in, at 34 percent, and again when the returns make their way to the entrepreneur and the other owners. All of them are likely to be in the 40 percent bracket for the personal income tax—the combined effective tax rate is close to 60 percent. The entrepreneur first gives a large piece of the action to the inactive owners who put up the capital, and then surrenders well over half of the remainder to the government.

The prospective entrepreneur will likely be attracted to the easier life of the investor who uses borrowed money. How much easier it is to put up a shopping center, borrow from a pension fund or insurance company, and deduct everything paid to the inactive investor.

Today's absurd system taxes entrepreneurial success at 60 percent while it actually subsidizes some leveraged investments. Our simple tax would put the same low rate on both activities. A huge redirection of national effort would follow. And the redirection could only be good for national income. There is nothing wrong with shopping centers, apartment buildings, airplanes, boxcars, medical equipment, and cattle, but tax advantages have made us invest far too much in them, and their contribution to income is correspondingly low. Real growth will come when effort and capital flow back into innovation and the development of new businesses, the areas where confiscatory taxation has discouraged investment. The contribution to income from new resources will be correspondingly high.

Total Potential Growth from Improved Incentives

We project a 3 percent increase in output from increased total work in the U.S. economy, and an additional increment to total output of 3 percent from added capital formation and dramatically improved entrepreneurial incentives. The sum of 6 percent is our best estimate of the improvement in real incomes after the economy has had seven years to assimilate the changed economic conditions brought about by the simple flat tax. Both the amount and the timing are conservative.

Even this limited claim for economic improvement represents enormous progress. By 2002, it would mean each American will have an income about $1900 higher, in 1995 dollars, as a consequence of tax reform.

LIFE IN A 19 PERCENT WORLD

What would life be like in a world with a 19 percent flat tax? The most important change in our behavior is that we would spend our time thinking about producing goods and services and improving productivity instead of remaining obsessed with getting advice on how to exploit tax-advantaged opportunities. With 40 percent top marginal rates, many high-income people feel that they cannot afford to reveal *any* significant income to the IRS. They put great effort into reducing taxable income and diverting their incomes to tax-free destinations. At 40 cents on the dollar, dishonesty is lucrative. At 19 percent, most people would relax. Evasion and avoidance are far less profitable at 19 percent than at 40 percent. Conversely, keeping 81 cents of every additional dollar of income is a true stimulus to produce as much as possible. With taxes taking no more than 19 cents from each additional dollar at every income level, most people will pursue those economic activities that bring the highest return and the most satisfaction, rather than the ones that minimize taxable income.

Think of the everyday kinds of decisions most people make that are governed by a steeply graduated tax-rate structure. Tickets for box seats at baseball stadiums, club memberships, business travel, company cars, and a host of other business outlays that incorporated and unincorporated firms regularly purchase, would now cost the owners of that business 81 cents of after-tax income, rather than the current 60 cents. Business would be expected to run a tighter ship with the much higher returns that a 19 percent rate affords over current high rates.

Those who believe that life would grind to a halt with the loss of deductions for interest and

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charitable contributions need to consider how they would alter their lives the morning the flat tax took effect. They would fire their lawyers and accountants. Instead, they would seek advice and information on sound economic investments. Perhaps most important, for the ordinary working American, the 19 percent world would abolish the annual nightmare of tax-return preparation in April. Both Forms 1 and 2 could be filled out in a few minutes on the basis of records that everyone keeps anyway.

NOTES AND REFERENCES

Data on labor force participation are from table A-13, Employment Status of the Civilian Noninstitutional Population by Age, Sex, and Race, *Employment and Earnings*, winter 1993/94.

On taxes and labor supply, see the *Journal of Human Resources*, Special Issue on Taxation and Labor Supply 25, no. 3 (summer 1990), and Jerry Hausman, "Taxes and Labor Supply," in Alan J. Auerbach and Martin Feldstein, eds., *Handbook of Public Economics*, vol. 1, chap. 4 (Amsterdam: North Holland, 1985), pp. 213-63.

On the effect of a flat-rate tax on capital formation, see Alan J. Auerbach, Laurence J. Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform," *International Economic Review* 24, no. 1 (February 1983): 81-100, and Auerbach and Kotlikoff, *Dynamic Fiscal Policy* (Cambridge: Cambridge University Press), 1987.

Testimony of Robert S. McIntyre
Director, Citizens for Tax Justice
Regarding Proposals for a Flat-Rate Consumption Tax
Before the Joint Economic Committee
May 17, 1995

I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

According to Chairman Mack, "The purpose of this hearing is to explore how the implementation of a flat tax would impact economic growth in the United States." In other words, the question before the Committee today is the following:

How would very large tax increases on middle- and low-income families, coupled with huge tax cuts for the very rich, affect the economy?

We believe the answer to this question is quite clear. Higher taxes on average American families to pay for tax cuts for the wealthy is a terrible idea, both unfair and bad economics. That so-called "supply-side" policy was tried in the Carter and early Reagan years, and failed so miserably that President Reagan himself rejected it. We should not repeat those mistakes again.

1. The Great Middle-Class Tax Hike

There is little or no disagreement among serious analysts that replacing the current, progressive income tax with a flat-rate tax would dramatically shift the tax burden away from the wealthy—and onto the middle class and the poor.

Indeed, it seems hard to deny this obvious fact. Right now, our personal income tax starts with a zero effective rate (or less) on lower-income families (up to about $23,200 for a family of four) and goes up to a 39.6 percent top marginal rate on the incomes of the best-off one percent. Replace that with a flat-rate tax of, say, 20 percent and clearly the rich will pay far, far less in taxes. This effect would be compounded by the fact that the leading flat-rate plans (from Rep. Armey and Sen. Specter) are based on a plan put forward by Robert Hall and Alvin Rabushka that is designed to tax only consumption rather than

Treasury's Analysis of the Armey Flat Tax Raising the Same Amount as Current Law

		Tax Changes Under Armey	
Income Group	Average Income	17% rate, reduced exemptions	22.6% rate, proposed exemptions
$0-10,000	$5,650	$ +310	$ +255
$10-20,000	$15,020	+1,775	+810
$20-30,000	$24,880	+1,960	+895
$30-50,000	$39,430	+1,740	+710
$50-75,000	$61,580	+1,990	+1,010
$75-100,000	$85,840	+2,120	+1,855
$100-200,000	$129,900	+295	+1,670
$200,000+	$476,960	-51,420	-30,480

Figures for the Armey plan include wage and pension taxes, fringe benefits taxes and "business" taxes.
Sources: U.S. Treasury Dept.; Citizens for Tax Justice (1995).

income.[1] (This result would be achieved by allowing immediate deductions for tangible business investments and by exempting interest, dividends and capital gains from individual taxation.) Thus, not only would the flat tax rate on the wealthy be much lower, but a large share of the wealthy's income wouldn't be taxed at all. That inexorably would leave middle- and low-income families holding the bag.

At a 1982 Senate Finance Committee hearing on various tax proposals (including an Armey-style plan), the Reagan Treasury Department testified that "any" flat-rate tax "would involve a significant redistribution of tax liability" away from the wealthy and onto average taxpayers. More recently, the Treasury Department has undertaken a detailed analysis of Rep. Armey's specific flat-tax plan.[2] Once Rep. Armey's proposed exemptions are adjusted downward to avoid the huge revenue losses the plan would otherwise entail, Treasury's analysis shows that the typical family would pay close to $2,000 a year in additional taxes under the Armey flat tax. Very rich people, however, would get tax cuts averaging more than $50,000 each.[3]

Treasury's findings have been confirmed by the authors of the original Armey and Specter-style flat tax. In their 1983 book, *Low Tax, Simple Tax, Flat Tax*, Hall and Rabushka noted that their flat tax "will be a tremendous boon to the economic elite."[4] They honestly delivered what they admitted was "some bad news": "it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people."[5] In fact, much like Treasury, Hall and Rabushka calculated that their flat tax would

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[1]Hall and Rabushka used to be very reluctant to admit that their plan was a consumption tax. At a Senate Finance Committee hearing back in 1982, Sen. Bill Bradley asked Hall: "So you are advocating a consumption tax?" To which, Hall responded: "That's right, but we are careful not to label it as a consumption tax."

In their recent book, *The Flat Tax* (1995), Hall and Rabushka are less reluctant than confusing. They variously tout their plan, often in juxtaposed paragraphs, as (a) an "airtight tax on . . . income" that "achieve[s] the goal of taxing all income exactly once" and (b) "a tax on consumption" only. *The Flat Tax*, pp. 72-73. Obviously, however, their plan cannot be both an income tax *and* a consumption tax.

[2]Rep. Armey has proposed a variation on the Hall-Rabushka flat tax, with a lower 17% tax rate and larger exemptions. He also proposes to repeal the earned-income tax credit for low- and moderate-income working families and the federal estate tax on very large estates (as do Hall and Rabushka).

[3]See U.S. Treasury Department, Office of Tax Analysis, "A Preliminary Analysis of a Flat Rate Consumption Tax" (1995). Treasury's figures have been slightly adjusted here to take account of Rep. Armey's proposals to repeal the earned-income tax credit and the estate tax. With those changes, but before adjusting Rep. Armey's exemptions downward, Treasury's analysis indicates that the Armey flat tax would increase the budget deficit by $178 billion a year (ignoring transition issues).

Alternatively, if Rep. Armey's exemptions are kept as proposed, but his rate is increased (to about 22.6%) to avoid revenue losses, the redistributional effects are similar, although less pronounced. Sen. Specter's 20% flat-tax proposal, which has smaller exemptions than Rep. Armey has proposed, is intended to be revenue neutral, and would have redistributional effects approximately in the mid-range of Treasury's estimates for the Armey plan.

[4]Robert Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (1983), p. 67.

[5]*Id.*, p. 58.

raise taxes by $1,400 to $2,400 year (in today's dollars) on families earning between $25,000 and $75,000. But "the truly successful get a better and better deal," they point out. "Families with incomes around [$285,000] receive tax breaks of about 7 percent of income, those with incomes of [$1.5 million] get 10 percent, and the handful with incomes approaching [$4 million] get 13 percent."[6]

To be sure, some flat-tax advocates have been less than fully candid about the effects of their plans. Representative Armey, for example, tries to sell his flat tax by (a) denying that his proposed 17% rate and high exemptions entail a huge revenue shortfall, (b) nevertheless insisting that almost everyone will get a tax cut, and (c) talking only about the wage portion of his tax, while pretending that nobody pays the business sales tax part (even though it would apply to everything from groceries to health care to new homes) or his tax on fringe benefits.

To supplement Treasury's analysis, we have prepared some detailed examples of how the Armey flat tax would affect typical families, focusing for simplicity on non-elderly couples with two children, and based on actual tax-return and Census data (aged to 1996 levels). Our results are similar to those shown in the tables presented by the Treasury and by Hall and Rabushka in 1983. For example:

- **Family income: $25,000.** Under current law, a family of four earning $25,000 pays essentially nothing in combined personal and corporate income taxes. (What taxes would otherwise be due are offset by the earned-income tax credit, which would be repealed under the Armey plan, and apparently by Sen. Specter's plan as well.) Under the Armey plan, with its proposed exemptions but with a 22.6% break-even tax rate, such a family would typically pay $810 in taxes on its $3,600 in fringe benefits and $1,540 as its share of the business tax. Thus, its tax bill under the Armey flat tax would increase by about $2,400. Under the alternative scenario, with a 17% tax rate, but lower exemptions, this family's tax bill would increase by almost $3,700.
- **Family income: $45,000.** Under current law, this family's tax bill would typically be about $3,800. Under the Armey plan, its taxes would increase by $1,740 to $4,200 a year, depending on the version.
- **Family income: $85,000.** Current law personal and corporate income taxes on this family would typically amount to $11,140. Under the Armey plan, wage taxes alone would be $10,400 to $11,650. When taxes on fringe benefits and the business tax are added in, this family would owe $4,600 or more a year in additional taxes.
- **Family income: $500,000.** Under current law, this family would pay $154,000 in combined personal and corporate income taxes. Under the Armey plan, the family's tax would be slashed by half or more—for a tax cut of between $78,000 and $93,000 annually.

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[6] *Id.*, p. 59. Dollar figures put forward by Hall and Rabushka in 1983 have been adjusted to today's dollars. In their 1995 revision of their book, Hall and Rabushka are considerably less forthcoming about the adverse distributional consequences of their plan, asserting that "There is no way to tell." Robert E. Hall and Alvin Rabushka, *The Flat Tax* (1995), p. 92.

Example of Tax Changes under the Armey "Flat Tax"

Non-Elderly Couples with Two Children, 1996

(Business tax allocated by consumption)

Income*	**$ 15,000**	**$ 25,000**	**$ 45,000**	**$ 60,000**	**$ 85,000**	**$130,000**	**$ 500,000**
Earned income	12,950	22,970	43,180	57,620	80,700	116,100	322,400
Interest, dividends, capital gains, etc	120	320	590	1,080	1,900	7,100	118,300

**Includes cash income not subject to tax, such as tax-exempt interest, etc.*

Current Law Income Taxes—							
Tax return total income	$ 13,070	$ 23,290	$ 43,770	$ 58,700	$ 82,600	$123,200	$ 440,700
Adjustments	160	200	290	330	510	1,500	7,900
AGI	12,910	23,090	43,480	58,370	82,090	121,700	432,800
Personal exemptions (4)	10,200	10,200	10,200	10,200	10,200	10,200	—
Deductions (standard or itemized)	6,750	6,750	8,820	10,850	15,610	23,650	56,800
Taxable income	—	6,140	24,460	37,320	56,280	87,850	376,000
Tax before credits	—	920	3,670	5,600	10,530	19,370	118,590
Credits (w/o EITC)	—	40	80	90	100	190	1,800
Tax before EITC	—	880	3,590	5,510	10,430	19,180	116,790
Earned-income tax credit	3,300	1,150	—	—	—	—	—
Current personal income tax	**$ -3,300**	**$ -270**	**$ 3,590**	**$ 5,510**	**$ 10,430**	**$ 19,180**	**$ 116,790**
Corporate income tax	**$ 130**	**$ 180**	**$ 210**	**$ 340**	**$ 710**	**$ 2,510**	**$ 37,300**
Total current income taxes	**$ -3,170**	**$ -90**	**$ 3,800**	**$ 5,850**	**$ 11,140**	**$ 21,690**	**$ 154,090**

Armey Flat Tax	**22.6% rate, proposed exemptions**						
Earned income	$ 12,950	$ 22,970	$ 43,180	$ 57,620	$ 80,700	$116,100	$ 322,400
Exemptions	34,700	34,700	34,700	34,700	34,700	34,700	34,700
Taxable earned income	—	—	8,480	22,920	46,000	81,400	287,700
Tax on earned income	$ —	$ —	$ 1,920	$ 5,180	$ 10,400	$ 18,400	$ 65,000
Taxable fringe benefits	2,300	3,600	5,800	7,200	8,600	9,400	9,600
Tax on fringe benefits	$ 520	$ 810	$ 1,310	$ 1,630	$ 1,940	$ 2,120	$ 2,170
"Business" tax	$ 1,000	$ 1,540	$ 2,310	$ 2,930	$ 3,490	$ 4,000	$ 8,500
Total Armey tax at 22.6%	**$ 1,520**	**$ 2,350**	**$ 5,540**	**$ 9,740**	**$ 15,830**	**$ 24,520**	**$ 75,670**
Tax change under Armey	***$ +4,690***	***$ +2,440***	***$ +1,740***	***$ +3,890***	***$ +4,690***	***$ +2,830***	***$ -78,420***

Armey Flat Tax	**17% rate, reduced exemptions**						
Earned income	$ 12,950	$ 22,970	$ 43,180	$ 57,620	$ 80,700	$116,100	$ 322,400
Exemptions	12,200	12,200	12,200	12,200	12,200	12,200	12,200
Taxable earned income	750	10,770	30,980	45,420	68,500	103,900	310,200
Tax on earned income	$ 130	$ 1,830	$ 5,270	$ 7,720	$ 11,650	$ 17,660	$ 52,700
Taxable fringe benefits	2,300	3,600	5,800	7,200	8,600	9,400	9,600
Tax on fringe benefits	$ 390	$ 610	$ 990	$ 1,220	$ 1,460	$ 1,600	$ 1,630
"Business" tax	$ 750	$ 1,160	$ 1,740	$ 2,200	$ 2,630	$ 3,010	$ 6,400
Total Armey tax at 17%	**$ 1,270**	**$ 3,600**	**$ 8,000**	**$ 11,140**	**$ 15,740**	**$ 22,270**	**$ 60,730**
Tax change under Armey	***$ +4,440***	***$ +3,690***	***$ +4,200***	***$ +5,290***	***$ +4,600***	***$ +580***	***$ -93,360***

Notes: Current corporate income taxes are allocated based on capital ownership. Under the flat tax, taxes on fringe benefits are allocated to workers receiving those benefits; and the remaining business taxes are allocated based on consumption, following the lead of Hall and Rabushka, who say that "[t]he flat tax, by expensing investment, is precisely a consumption tax." *The Flat Tax* (1995), p. 71.

2. How Would Raising Taxes on the Middle-Class and the Poor —to Pay for Tax Cuts for the Rich—Affect the Economy?

The notion that shifting the tax burden away from the rich and onto the middle-class and poor will help the economy is not a new idea. Often referred to (even by proponents) as "trickle-down" economics,[7] this approach had its most recent major test in the so-called "supply-side" tax bills of 1978 and 1981. In the Carter administration, the 1978 Revenue Act sharply reduced taxes on capital gains and expanded corporate tax breaks. Then Ronald Reagan's 1981 tax act slashed taxes on corporate profits and personal investment income. Meanwhile, as taxes plummeted on the affluent, inflation and rising payroll taxes led to higher and higher effective tax rates on nine out of ten American families.

"Supply-side" proponents of the tax-shift policies adopted during the Carter and early Reagan years confidently predicted that their approach would produce an investment-led economic boom. But despite the rosy scenarios, the supply-side experiment failed. After the 1978 capital gains tax cut was enacted, for example, the GDP dropped by 1% over the next year and a half.[8] Likewise, adoption of the 1981 supply-side tax-loophole bill was followed by the deepest recession since the 1930s.

After several years of weak business investment, rampant tax-sheltering and huge budget deficits, President Reagan himself switched gears. The supply-siders were banished and Reagan helped lead the charge for the loophole-closing 1986 Tax Reform Act. The result was a fairer, more efficient tax code that treats income more equally, regardless of how it's earned or used. And to the consternation of the supply-siders, productive investment surged dramatically after the loopholes were closed and business tax avoidance was curtailed.

Real business investment grew by 2.7% a year from 1986 to 1989. That was 43 percent faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually falling at a 2% annual rate from 1981 to 1986. As former Reagan Treasury official, J. Gregory

Annual Rates of Change In Business Investment in the 1980s
(Real Private Non-Residential Fixed Investment)

	1981-86	1986-89
All Business Investment	**+1.9%**	**+2.7%**
Structures	**-0.7%**	**+0.2%**
Industrial buildings	-6.8%	+8.0%
Commercial buildings	+6.8%	-1.3%
All other structures	-3.4%	-1.4%
Equipment	**+3.5%**	**+4.1%**
Industrial equipment	+0.1%	+4.0%
Computers & office equip.	+22.6%	+8.8%
All other equipment	+2.8%	+3.2%
ADDENDUM: Industrial equipment & bdgs.	**-2.0%**	**+5.1%**

U.S. Dept. of Commerce, Bureau of Economic Analysis, Mar. 1992

[7]"Supply side is 'trickle down' theory," Reagan's OMB director David Stockman was quoted as admitting in *The Atlantic*, December 1981.

[8]Over the 12 months *prior* to enactment of the 1978 capital gains tax cut, the real GDP had grown by 5.8%.

Ballentine, told Business Week: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

More recently, our economy has enjoyed an investment-led economic rejuvenation following the increases in the top tax rates on corporations and the best-off people in President Clinton's 1993 deficit reduction act. Indeed, from the third quarter of 1993 (when the deficit reduction act was approved) through the end of 1994, real GDP rose by 5.7%, led by real business investment growth of 18.4%. The stock market is at a record high. Indeed, the economy has done so well since 1993 that the Federal Reserve has taken repeated steps to try to slow it down.

One might have thought—or at least hoped—that the soak-the-poor-and-the-middle-class tax-shift theories of the discredited supply-siders would have been laid to rest by the events of the past two decades. But sadly, that does not appear to be the case. The expensive new corporate and high-income loopholes included in the House-passed "Contract with America" tax bill are essentially an attempt to repeat the failed loophole-based tax policies of the Carter and early Reagan years. (The bill even includes a "Trojan Horse" of children's tax credits to divert attention from the sharp reductions in capital gains and corporate taxes that are the true centerpiece of the plan.)

The Hall-Rabushka flat-rate consumption tax and its variants are an attempt to go much further. Among other things, the corporate income tax would be entirely repealed—replaced with what amounts to a modified value-added tax. Interest would be taken entirely out of the tax base. Dividends would no longer be taxed, nor would most capital gains. In short, the flat-tax proponents want to consolidate the current special tax breaks for income from capital into one giant, all-encompassing loophole. Then, on top of that, graduated tax rates would be abandoned in favor of a single flat tax rate.

The unreconstructed supply-siders who promote these regressive tax changes offer fanciful predictions about how their plan to shift the tax burden away from the rich and onto the middle class and the poor would supposedly boost economic growth. But they have been consistently wrong in the past, and they are wrong once again. Indeed, the flat-tax plan is so poorly worked out, that it would produce a major, negative upheaval in the economy that could take years to overcome.

3. Conclusion

Proposals for a flat-rate consumption tax would move our tax system in exactly the wrong direction, for both our economy and for tax fairness. Rather than expanding tax entitlements for corporations and the well off and lowering their tax rates, we should seek *real* tax reform. In our view that means that existing loopholes should be curtailed, tax laws simplified, and graduated tax rates maintained.[9]

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[9]In CTJ's recent publication, *The Hidden Entitlements* (1995), we outline the kinds of loophole-closing measures that could and should be adopted to simplify and improve the tax system to promote both fairness and economic growth. We also look forward to analyzing the major income tax reform measure that House Minority Leader Richard Gephardt has promised to introduce later this spring.

Appendix: The structure of the Armey-Specter-Hall-Rabushka flat tax.

The Hall-Rabushka flat tax, and its Armey and Specter variants, would replace the current personal and corporate income taxes with a new tax that is conceptually identical to a "subtraction-method" value-added tax, a version of a national sales tax, with two major modifications: First, imports would be exempt from the flat tax, while exports would be subject to tax. Second, to mitigate the regressivity of the VAT, cash wages, pensions received and other cash earned income would be taken out of the VAT base (i.e., deducted by businesses) and taxed directly to individuals, with exemptions. Thus, structurally, the flat tax is exactly equal to a value-added tax with an import incentive, an export disincentive and a personal rebate based on a percentage of a capped amount of cash wages, pensions and other earned income.[10]

The "business" tax: Although the corporate income tax would be repealed, its structure and most of its complexity would be retained in order to collect the modified value-added tax that is the centerpiece of the flat tax plan.

The flat-tax's business tax form, which would be filed by corporations, self-employed people, partnerships, unincorporated companies, investors in rental properties, and anyone else engaged in business activities, would retain most of the trappings of the current corporate income tax (including the numerous, necessary rules defining gross receipts and allowable deductions) with the following modifications:[11]

- Capital investments in tangible property (such as machinery, buildings, land, inventories, etc.) would be expensed, rather than depreciated or amortized over time. This is consistent with the stated goal of taxing only personal consumption, and is intended to produce a zero tax rate on profits from new capital investments.
- Non-cash wages (i.e., non-pension fringe benefits such as employee health insurance) would not be deductible, and thus (unlike current income tax law) would be taxed. This is consistent with the treatment of wages generally under a normal value-added tax, but can also be seen as a withholding tax on employee fringe benefits.
- Interest income would be exempt from tax, and business interest expenses would not be deductible.
- Banks and other financial institutions would include in gross receipts the value of services provided to customers "for free" (i.e., "free" checking accounts, loan services accounted for by higher interests rates, etc.).
- Business entertainment outlays would be fully deductible (rather than only 50% deductible as under current law).

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[10] Businesses compute a typical "subtraction-method" value-added tax by adding up their taxable gross receipts and subtracting the cost of previously taxed items. Thus, in computing the VAT, businesses deduct their purchases from other businesses, whether for supplies, services, machines, land or whatever. (In another, more common form of a value-added tax, known as a "credit-invoice" VAT, businesses get a tax credit for taxes paid on purchased items. In general, this produces the same result as a "subtraction-method" VAT.) Ultimately, the total tax base for a VAT is equal to retail sales of taxable items, and a VAT is thus equivalent to a retail sales tax. As noted, however, the flat tax base differs from a usual VAT, however, in that wages are deducted by businesses, and taxed at the personal level.

[11] The business "postcard" tax form is a fraud, since it includes virtually none of the detailed information required for taxpayers to compute their taxes or for the IRS to audit them.

■ Businesses with an excess of deductions over receipts would carry over the excess, on which the government would pay interest when the amounts are eventually deducted.[12]

After a long and troublesome transition,[13] the long-term impact of the flat tax's business tax is supposed to approximate a consumption tax (except for its odd treatment of imports and exports). As Hall and Rabushka note in the revised version of their book, "The business tax is not a profit tax."[14] Instead, "The flat tax, by expensing investment, is precisely a consumption tax."[15]

Although flat-tax backers seem to think that their business sales tax would be immune from political pressures, this is not the experience with value-added taxes in Europe, nor with sales taxes in the states. On the contrary, lobbying for special exemptions and loopholes is rampant

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[12]Hall and Rabushka argue that their plan will raise more revenues from "business" than does the current personal and corporate income tax. Since they also assert that their plan ultimately taxes only personal consumption, this seems disingenuous on its face. In fact, any added tax revenues that might be collected from businesses under the flat tax appear to reflect a combination of short-term transition revenues that will decline sharply over time and new taxes on workers, rather than any actual increase in taxes paid by businesses and their owners. Although Hall and Rabushka assert that their business tax will somehow bring in lots of currently untaxed business receipts, they offer little or no evidence for this claim. As noted in the text, in terms of the business-filed tax forms, Hall and Rabushka's business tax base would be much like the current system (with similar underreporting of receipts and overstating of expenses), with the exceptions noted in the text. As for some of those notable exceptions:

■ Currently, corporations report considerably more overall taxable interest income than interest expenses, while individuals report somewhat less in taxable interest than they deduct (mainly for mortgage interest). Whether making interest totally tax-free would gain revenues seems highly doubtful.

■ Allowing business investments in tangible property and inventories to be deducted immediately, rather than depreciated or amortized (or, in the case of land, non-deductible), would be a huge reduction in the tax base (compared to the current income tax), cloaked in the short-term by the fact that Hall and Rabushka suggest wiping out all remaining depreciation and amortization deductions on existing assets.

■ Employer-paid fringe benefits would no longer be deductible. But Hall and Rabushka expect that the burden of this tax change would not be borne by businesses, but would be quickly shifted to employees.

■ Employer-paid social security taxes would no longer be deductible. But again, Hall and Rabushka correctly expect that this tax change would be borne by workers, not by businesses.

[13]Hall and Rabushka seem to prefer that there be no transition rules to deal with, for example, depreciation deductions for existing equipment and interest deductions on existing loans. Under this scenario, they say, for example, that General Motors' tax bill would increase by a staggering $2.6 billion a year in the early years of the flat tax (considerably more than GM's total profits), due to lost depreciation and interest deductions. In contrast, they say, Intel's tax bill would plummet by almost $1 billion because of fortuitous differences in the timing of its recent investments. See Robert E. Hall and Alvin Rabushka, *The Flat Tax* (1995), pp. 64-66.

Alternatively, Hall and Rabushka suggest a transition rule that would allow depreciation deductions on past investments, paid for by higher tax rates (primarily on wages and fringe benefits). *Id.* p. 78-79. They also suggest a possible transition rule for interest that would essentially require renegotiation of all existing loans, and is premised on the unsupported prediction that interest rates would immediately fall by a fifth upon adoption of the flat tax. *Id.* p. 78-79.

[14]Robert E. Hall and Alvin Rabushka, *The Flat Tax* (1995), p. 64.

[15]*Id.* p. 71.

with those taxes, cheating is widespread and administrative costs are generally as high or higher than for income taxes.[16]

Personal taxes: Individuals would pay taxes directly only on wages, pensions, unemployment compensation and certain other income characterized as "earned." Individual business owners, partners, etc. could report their earned income on the "wage tax" form by paying themselves a salary (thereby taking advantage of the wage-tax exemptions), but they would have to file the business tax form as well.

Besides smaller type, consolidation of several lines into cryptic, hard-to-audit summaries and elimination of some anti-fraud provisions, the major changes that the wage-tax form entails from the current income tax form include:[17]

Personal Income:
- There would be a 100% exclusion for interest income.
- There would be a 100% exclusion for dividends.
- There would be a 100% exclusion for capital gains from selling stocks and other intangible assets.
- Business receipts, rents, royalties, partnership receipts, farm receipts and so forth would not be reported on the personal tax form, but instead on the separate business tax form.

Personal Adjustments, Deductions and Credits:
- None of the current adjustments, for self-employed pension contributions, IRAs, self-employed health insurance, FICA taxes, or alimony paid, would be allowed.
- Itemized deductions, for state and local income and property taxes, mortgage interest, charitable donations, extraordinary medical expenses, job-related expenses and so forth would be eliminated. Sen. Specter's plan, however, would allow charitable deductions of up to $2,500 a year and mortgage interest on up to $100,000 in debt for all tax filers with such outlays, thereby greatly increasing the number of taxpayers itemizing deductions.
- The child-care credit, earned-income tax credit for the working poor, credit for excess social security taxes withheld, and all other tax credits would be repealed.

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[16]For a detailed discussion of the many problems with European value-added taxes, *see* Citizens for Tax Justice, *No Sale: Lessons for America from Sales Taxes in Europe* (1988).

[17]Neither the personal nor the business tax form includes a line for self-employed people to pay their Social Security taxes. This may have been an oversight, or, like the consolidation of wages, pensions, IRA distributions, etc. onto one line, it may have been necessitated by the goal of fitting the tax form on a large index card.

STATEMENT OF DR. RICHARD W. RAHN ON BEHALF OF THE BUSINESS LEADERSHIP COUNCIL ON THE FLAT RATE TAX BEFORE THE JOINT ECONOMIC COMMITTEE, MAY 17, 1995

Mr. Chairman and Members of the Committee, thank you for giving me this opportunity to testify today on the flat rate tax. As a member of the Board of Directors of the Business Leadership Council, I am testifying on behalf of the Council. I also serve as President of the Novecon companies, which were established to create and operate joint ventures in the former Soviet Union and Eastern Europe.

INTRODUCTION

Most thoughtful observers understand that the present income tax system is increasingly dysfunctional and must be replaced. The rising complexity and costs of management and compliance with the existing tax system have made it not only unfair but increasingly uneconomic. The present income tax system is strongly biased against productive saving and investment, which in turn has sharply reduced our rate of capital formation and hence the standard of living for most Americans. New technologies, such as electronic money and the "smart card", will make the existing tax system increasingly easy to escape for those who so choose. Finally, the existing system is intrusive, subject to, and all too often abused by, government officials, and is not compatible with a free society, in which citizens should be considered innocent until proven guilty and not have to fear their own government.

Thus, the question should now be with what to replace the existing income tax and how much money should the new system raise. We cannot properly determine what type of tax system we should have until we determine what the revenue goals for the new system should be.

From the end of World War II until the late 1970s, there was a common belief that our economic and societal ills could be cured by increasing the role of government. As a result, government grew larger and larger both in absolute and relative terms, not only in the United States but in much of the rest of the world. Fair-minded people increasingly understood that the Keynesian economists were wrong, and that distinguished economists, such as Frederick von Hayek and Milton Friedman, had both a better understanding of how the economy operates and better prescriptive solutions. They taught us that beyond a certain point increasing taxes, government spending and regulations did more to reduce the social welfare than to increase it. The increasingly widespread recognition that government could, and indeed had become counterproductive, ushered in the Reagan revolution. The result has been that government taxation and spending have not grown relatively over the past twelve years, even though regulation has continued to grow in both relative and absolute terms.

During the past twenty years, serious academic work has been done on the appropriate size of government not only for the United States, but for the rest of the world as well. The empirical evidence that government taxing, spending, and regulation is well beyond the optimum point is now overwhelming, and all Americans are suffering as a result. Specifically, we now know that the social welfare and economic growth would be maximized if government was one-quarter or less of Gross Domestic Product, as contrasted with the present more than one-third.

Knowing this, it makes no economic or political sense to design a new tax system to raise as much money on a static revenue basis as the existing system. We know that as we downsize government in relative terms, economic growth rates will increase. We know that as we reduce high marginal tax rates and the current tax bias against saving and investment, we will increase the supply of productive labor and have a higher level of capital formation, which will lead to higher rates of economic growth.

Because the majority in this Congress has had the courage to develop a path to a balanced budget that slows the rate of growth of government spending, the federal government share of GDP should fall to 18% by 2003. History tells us that economic growth will increase as a result. This means that you can generate the same tax revenue at reduced tax rates. At the same time, because of higher growth, there will be fewer people in poverty, thus reducing the demands on government assistance programs, and hence government spending.

Fair minded people understand that the reason you wish to slow the growth of government spending is not because you are "mean spirited" or "tools of the rich". It is because you understand that a smaller government will mean that most Americans and particularly poor Americans, will have much greater opportunity and live much better. It is too bad that some in the media cannot distinguish between the "name" of government programs and the cost-effectiveness of these programs. Eliminating a government program with a compassionate name, but whose cost to the taxpayers is greater than the benefits to the recipients, is the compassionate and responsible thing to do. Because some of your political opponents and some in the media are irresponsible is no reason for you to stoop to their level. For America's sake, continue to have courage.

Unfortunately, the Congress has let itself get trapped by budget rules that make no sense. Again, I am referring to the requirement of "relatively static" revenue estimates for tax and spending changes. These rules make no economic sense, and they make no political sense, now that a majority in Congress favor economic growth and opportunity over static redistributionism. When the rule makes no sense, change it. (The left in the media and their academic and political allies will scream; but the American people vote on performance, not on arguments about whose tax forecast model is correct.)

The reason it is important not to be slaves of the wrong rule is that the current rule will force you to have higher tax rates and more onerous provisions than you ought to with the flat tax proposal. This is equally true for consumption-based income tax plans and for the national sales tax proposals. Because of the static revenue trap, all of the proposed plans will increase taxes on some sizable portion of the population, thus causing unnecessary hardship and political opposition.

There are three politically viable and economically sound alternatives that could replace the existing income tax: a so called consumed income or cash flow tax (Nunn-Domenici), a national sales tax, and a flat rate income tax (Armey.)

Even though all of the major proposals for a replacement tax are vastly superior to the existing tax system, none are perfect, and all will have problems in the transition period. These problems can largely be mitigated by reducing the maximum marginal tax rate from that which their proponents are proposing. This can be done responsibly, by further reducing the growth in spending so that eventually all levels of government are absorbing less than 25% of GDP (please see the chart at the back of this testimony). This would entail reducing federal spending into the neighborhood of 15-17%. In effect, virtually all businesses and individuals would be getting a "tax cut", thus mitigating their political opposition and reducing the impediments to work, saving, and investment. The higher economic growth engendered by the spending growth reductions and the less destructive tax system is likely to increase the absolute revenues for government to spend.

For the full benefits to occur of any of the income tax replacement plans now being discussed, they must be accompanied by drastic changes in the operations of the IRS. The necessary restricting of the IRS' ability to take actions without first proving willful wrongdoing, and greatly reducing the paperwork and documentation the IRS can require will indeed cause some revenue loss, but it is a small price to pay for a free society. A national sales tax ought not to be enacted without the repeal of the 16th Amendment, because without such a repeal there is a great danger that some future Congress will inflict on us both an income tax and a sales tax. At the same time, a flat tax ought not be enacted without the Congress curtailing the IRS.

THE FLAT TAX

Given that you have been provided with a considerable amount of information on the flat tax proposals, I will just briefly summarize their advantages, then discuss a couple of problems with the proposals, and finally suggest cures.

The Armey type of flat tax has many advantages over the existing tax system. The main advantages are that it would eliminate the double taxation of savings and investment; greatly reduce disincentives for productive activity because of its rate reduction; greatly reduce the time and cost of compliance because of its simplicity; and it would be perceived from a political standpoint as being fairer because of its flat rate, while in practice being highly progressive because of the large exemption and the shifting of the tax burden to the owners of business. All of the above advantages would cause the economy to grow more rapidly, thus bettering the lives of the great majority of the people, particularly low income people.

There are problems with the flat tax, as currently defined. It could have unintended consequences on some types of small businesses, particularly during the transition.

The flat tax also relies on several accounting devices and mathematical equivalencies at the business level in an effort to incorporate the entire economic value of the wage bill into the income tax base. The ultimate objective is to leave businesses as shells through which all tax consequences flow to individual workers and owners.

Flat tax proponents have a general notion of how such a simulated consumption tax will affect businesses, but there needs to be more examination of what these general notions will mean in specific cases. As a general proposition, flat tax advocates contend that over the long run, expanding businesses will do better under a flat tax and that contracting businesses will do worse. In general, capital-intensive manufacturing companies will tend to benefit from a flat tax. What about more labor-intensive and information-centered service sector firms?

In considering these questions, it becomes apparent that in the process of so completely altering the tax base, the flat tax will produce wild swings in tax liability among taxpayers. Most unsettling to business owners is the divergence that will emerge between the tax base of a business under the flat tax and the generally accepted accounting concept of its net profit/loss. In some instances, it appears that the flat tax drives a wedge between profits and taxable income and consequently may impose quite large tax liabilities on marginally profitable firms or even on firms operating at a loss.

These problems could be partially mitigated by reducing the flat tax rate to a rate no greater than 15%, as was discussed in the earlier part of the testimony, and allowing some deductions for government imposed taxes and fees.

Another problem is that some people now at the 15% bracket could see their marginal tax rates rise to 17% or 19%. Again, if the proposal is modified so that the rate is no higher than 15%, this problem disappears.

A number of people who receive all their income from interest and dividends will pay no tax even though they are rather wealthy. The fact is they have already paid the tax on the income used to generate the interest and dividends, but it will take a considerable amount of explanation and education for most people to understand and appreciate the reasons. This will be a formidable task, given the incentives for the opposition to be demagogic on the issue.

Finally, there is a great danger that the IRS will try to redefine interest, dividends, and capital gains income as salary income. Without strict prohibitions on the right and ability of the IRS to do so, we could end up with an even more intrusive tax system.

FURTHER DISCUSSION ON THE APPROPRIATE SIZE OF GOVERNMENT

It is a curious fact that the intellectual rationale behind most of the destructive actions of world leaders in this century stemmed from the ideas of three distinct groups all writing in the vicinity of London - the Marxists, the Fabian Socialists, and the Keynesians. The authors of these ideologies were not personally violent, and only the disciples of Marx advocated violence. Yet it is now unambiguously clear, not only that the Marxists added to the human misery of the 20th century, but also the Socialists and even the Keynesians unintentionally added to the misery to a lesser degree. The "fatal conceit", as Hayek put it, of all three schools of thought was the failure to understand the limits of government to do good rather than harm.

Fortunately, the nightmare of the big government utopians is behind us. Communism as a credible economic system had rotted away years before the "Berlin wall" which protected its collapse. Margaret Thatcher and Ronald Reagan ended what remaining political respectability the Keynesians had, as evidenced by "new Democrat" Bill Clinton calling for smaller government. The final obituary of intellectual statism as an attractive, all encompassing political idea occurred on April 29, 1995 when the British Labour Party (the world's longest running major socialist party) formally voted to drop its 77 year old commitment to nationalized industry.

Despite the fact that macroeconomic statism is a spent intellectual force, its microeconomic adherents, such as the extreme environmentalists, social and economic regulators, and the do-gooders who believe in doing good with other peoples' money are alive and well. Thus, the dilemma for the world's politicians: big government is rightly despised, but the intellectual rationale for its dismemberment has only partially been understood.

This political conundrum can be seen in the U.S. at the moment. Thoughtful people increasingly understand that the income tax is increasingly dysfunctional and needs to be replaced. Both a "flat tax" and forms of a "sales tax" are advocated as a replacement. The microeconomic statists have demanded that the replacement tax bring in as much revenue as the existing income tax on a static basis. Too many of the replacement tax advocates have acquiesced to this demand, which puts them in an almost impossible political position, because the replacement tax under these conditions merely shifts the tax burden, thus creating a whole new set of winners and losers. The losers will always be more vocal than the winners, and hence fundamental tax reform becomes a political impossibility.

The way out of the dilemma is to go back to basics. We now know that most governments in the world, including the U.S., Canada, Japan, and all of those in Western Europe, are too large to maximize the social welfare. If government is too big, a new tax structure ought to be designed to be the most efficient one for the "correct" size of government, not for a government that is too big. The new tax structure ought not to provide as much revenue on a "static" basis as the existing tax structure, but in fact may well provide more revenue on a "dynamic" basis over the long run. Viewed this way, fundamental tax reform is politically possible because there will be more "winners" than "losers" under the new tax system.

In the years after World War II, it became the conventional wisdom among the new generation of economists and their political and media followers, that increasing the relative size of government would lead to higher and higher levels of prosperity. The politicians became particularly fond of the Keynesian school because it gave them a rationale for increasing taxes and spending other peoples' money on their favored constituents. However, by the early 1970s, it became evident that the model was not working according to plan. Rates of capital formation and subsequently, economic growth fell in the U.S. and much of Western Europe, with a subsequent rise in unemployment levels.

By the early 1980s, it was evident that the low-government sector economies of some of the Southeast Asian countries were growing at much higher rates than had been thought possible, while growth in a number of the high-government sector economies was anemic at best. As a result, a number of economic researchers began looking at the relationship between the size of government and economic growth. Rather than the relationship being positive as was the conventional view, studies increasingly showed negative relationships. In an attempt to obtain an understanding as to what the optimum size of government might be (e.g. that which maximizes economic growth), several of us who were economists with the U.S. Chamber of Commerce at that time (1986), analyzed the relationship between rates of economic growth and government spending as a percentage of GNP for twenty-two countries for which there was adequate data. We found that slow downs in the rate of economic growth were significantly correlated with the growth in the government share of GNP. Our best estimate, given the data, was that government maximized economic growth when it was between fifteen and twenty-five percent of GNP.

In the years since, many more studies using both much more extensive time series and cross sectional data than we did in our work have been completed. The conclusions of these subsequent studies have both confirmed our early work and been more precise. For instance, in November 1994, the distinguished economist Gerald W. Scully, produced a study for the National Center for Policy Analysis, in which he concluded that: "to maximize economic growth, the average rate for federal, state, and local taxes combined should be between 21.5% and 22.9% of gross national product". (Currently in the US, total government taxation is approximately 31% of GDP and spending is approximately 34% of GDP). Scully also concluded that if the tax burden had been at the optimal level, economic growth would have averaged about two percent higher per year, and the "average American family would have had twice as much real income today as it actually has". Finally, he concluded that given the much higher rate of economic growth, even with the lower tax rate "government at all levels would have collected $11.6 trillion more in taxes" since 1949.

It should not be surprising that growth in government at some point begins to have negative rather than positive returns. Too little government can also reduce growth. Government needs to spend enough for basic law and order, for the national defense, to enforce private contracts, and for basic public health and education. However, all government spending entails extracting wealth from the private sector either by taxing or borrowing. The larger government spending becomes, the more severe these extraction costs become. The costs of borrowing crowd out private sector investment, reducing production, capital formation, and economic growth. High tax rates reduce the incentives to work, save, and invest, and involve ever-increasing rates of both public and private compliance and collection costs. Finally, most public spending is less efficient than private spending, both because it often misallocates resources and because the incentives for effective cost control are far less than with private sector spending. Government spending programs tend to develop their own constituency groups, and thus the political pressures to increase spending on the program have less and less to do with the general welfare. It is an age old problem, because there is a concentration of benefits of any government spending program, but a dispersion of costs throughout the population, thus creating a bias for higher than desirable levels of spending.

We now know that if government took one-quarter or less from the private sector, rather than the current one-third, we would be far richer as a nation, with higher levels of employment and much lower levels of poverty. We also know that high tax rates and high levels of taxation are counterproductive. (It is worth noting that despite huge changes in our tax rate structure over the past 35 years, the Federal government tax collections as a percent of GDP have remained remarkably constant at about 18.8%, never varying by more than + or - 1.4 % since 1960.)

The optimal size of government depends somewhat on the structure of government spending. The empirical evidence shows that defense spending, spending on goods and services, and infrastructure has modest negative returns, largely because of the inefficiency of the government procurement and management processes. Income maintenance and redistribution programs tend to have severe negative returns because of the work disincentives that typically are embodied in these programs, plus the inefficient and weak management.

It is now unambiguously clear that we should bring total government spending down approximately ten percentage points from 34% to 24% of GDP, if we are to maximize the social welfare, opportunity, and freedom of our citizens. At least two-thirds of this reduction should come from Federal spending. Such a reduction will require eliminating most counter-productive spending programs and changing Social Security and Medicare into true annuity and insurance programs.

The cold war is over, the socialists and Keynesians have entered the intellectual junk pile of history, but we are not yet free of microeconomic statists and political plunderers. Our freedom and prosperity will only be assured when the citizenry understands that we must limit government and requires the politicians to do so. The revolution is not yet won; only the beginning battles have been fought.

THE IRS AND TECHNOLOGICAL PROGRESS

Death and taxes are among life's certainties. Far less common, but much more enjoyable to contemplate, is the death of tax.

In fact, a little known technology may be about to accomplish what generations of Americans have joked and dreamed about - the annihilation of the existing income tax. But now it is becoming possible, and perhaps even necessary.

The income tax discriminates against savings and investment. Economic growth and job creation are penalized. As the tax system grows even more complex, and changes pile up on changes, the cost of compliance grows even more rapidly, becoming an unalloyed economic dead weight.

Think of the resources that would be freed, and the human happiness that would occur, if all the tax lawyers and accountants were put to work doing something useful. Think of all the gains to taxpayers once they were freed from the burden of compliance.

The cost is more than economic. The complexity of the system also causes fear. One rarely knows what the proper tax liability is. For most large businesses and many individuals, the only thing they know for certain is the amount they paid is wrong. And though the media reports every April of leading accounting firms and IRS offices each calculating a different liability from the same data may be amusing, the reality is otherwise. Each year, the IRS tries to send people to jail for not determining a liability that is, by the very nature of the system, almost impossible to calculate.

For centuries, people have paid their bills, and received their income by cash or check. These costly methods of payment may be coming to a rather abrupt end.

Electronic transfers greatly reduce the cost of transaction and the possibility of loss. Americans are now starting to pay their bills by using credit cards, and by inexpensive "Smart Phones". These systems provide customers with a full record of income and payments: good for record-keeping, but bad for privacy. In fact, the IRS is already working on a system to gather all your financial information electronically and prepare your tax return for you. That might crimp the tax lawyers and accountants a bit, but the Big Brother police state aspects should be at least as unpalatable.

There is, however, a technological alternative. The electronic version of the anonymous paper dollar is with us. An experiment is now underway, called "E-cash," operating in Amsterdam by a company named DigiCash. Individuals will be able to move their funds around the world, literally at the speed of light, from one bank to another or to a creditor, without the bank knowing to whom the money was paid, or the creditor knowing from which bank or even which country the money came.

Through the use of cryptographic technology (scrambled numbers for personal codes), the ease of conducting electronic transactions would be combined with the elegant anonymity of paying in cash. The two most important features of the "E-cash" system - security and anonymity - will be ensured by using cryptographic digital signatures to establish the authenticity of the payer, while at the same time assuring his anonymity and untraceability. The virtual electronic dollar bills will, at the same time, be assigned individual electronic serial numbers, which will also be checked for authenticity. The bank will know how much to pay and what code to pay it to, but will not know the owner of the receiving code; hence, the payee too remains anonymous.

Naturally, the IRS doesn't like it. But the matter may be beyond its control. In the next few months, Americans will be offered two competing versions of the future. The first is the society in which all of your transactions can be monitored by the government (and other interested parties). The second is where you as an individual choose which of your transactions will be made available to curious eyes, and which will remain anonymous.

Many in the government and other organizations will argue for a ban on anonymous systems, contending that such capabilities benefit primarily drug traffickers, money launderers, assorted terrorists and plain old tax dodgers. Libertarians, on the other hand, will warn of the dangers that accrue when government has almost total scrutiny of individuals. One does not have to envision what Hitler or Stalin could have done with such a system; just try to imagine the kind of ordeal investigators could inflict on anyone trying to get Senate confirmation for government service.

The fact is that the fears of both sides are correct. But some of the legitimate fears of the government can be mollified by repealing the existing income tax and substituting a tax that exempts capital, such as the flat tax or sales tax. Anonymous systems will make it easier for criminals and evaders to do what they are already doing successfully, especially as private encryption protocols are developed.

But without tax on capital income, it will not matter. The gains to the American people, economically and psychologically, will be magnificent. Even the government, which relies on public trust, will gain. And on such terms, that would be a very good thing.

Given the long history of taxpayer abuse by the IRS, and given that we have a tax system that is so complex that no one knows if they are in compliance, it is imperative that taxpayer rights be strengthened. The IRS continues to cause many taxpayers unnecessary anguish and huge financial costs, while the Administration and IRS continue to fight many of the constructive reforms that Members of Congress have proposed in H.R. 661, H.R. 390 and S. 258, collectively known as the "Taxpayer Bill of Rights 2."

The IRS and some members of its dependent class of tax lawyers argue that a number of the measures proposed to protect the liberty and wallet of taxpayers would be troublesome for the IRS to administer and could result in billions of dollars of lost tax revenue. They particularly object to the proposed increased sanctions for IRS misbehavior and the shifting of the burden of proof from the taxpayer to the government.

The founders of the United States correctly realized that the greatest threat to liberty and prosperity was large and intrusive government. We expect that the IRS is right when they say that some who owe taxes will be able to avoid them if the reforms are enacted. We believe that that is a small price to pay to regain some of our freedom and to increase prosperity and economic opportunity for all citizens.

It is widely recognized that the federal government is wasting hundreds of billions of dollars on programs whose costs clearly outweigh the benefits, thus denying economic opportunity for our poorest citizens and reducing the standard of living for the rest of us. Thus, the appropriate response by the Clinton Administration to a potential loss of tax revenue from the "Taxpayer Bill of Rights 2" should have been to reduce government spending and simplify the tax system. Unfortunately, the Clinton Administration, while well-meaning, was misguided, in choosing instead to endorse a continuation of the current unworkable system.

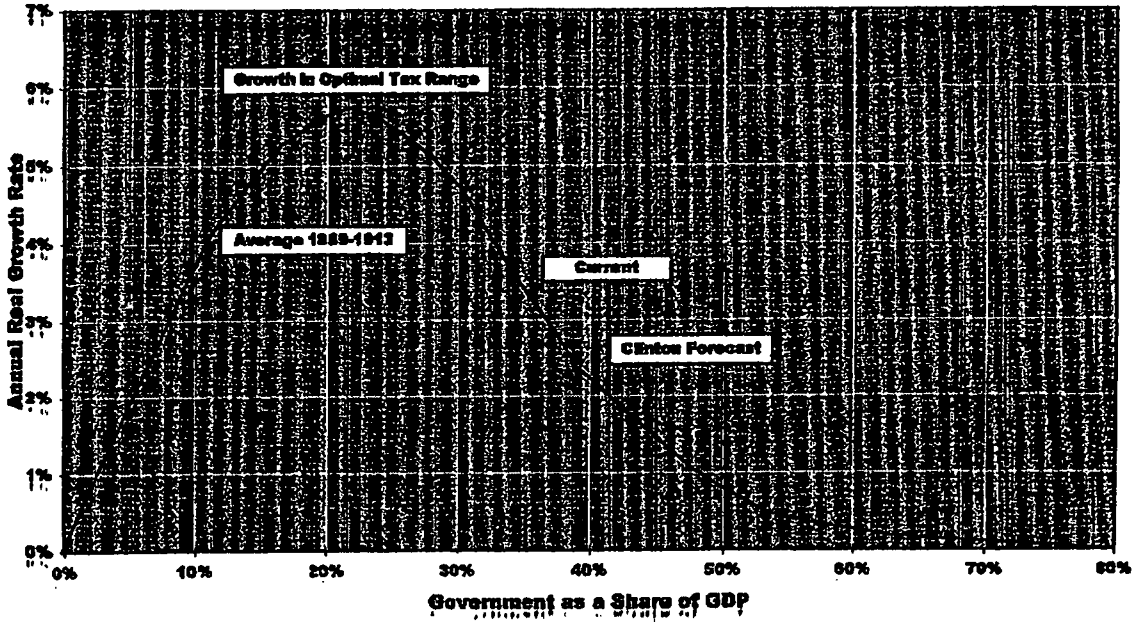
In the meantime, we urge those in Congress who care about increasing the liberty and prosperity of the American people to adopt "Taxpayer Bill of Rights 2" immediately.

CONCLUSION

The existing income tax must be replaced because it is now beyond repair. The flat tax (and the other major income tax replacement proposal, the national sales tax) would be a considerable improvement over the existing income tax. However, there are problems with the existing proposals, most of which can be fixed, by further reducing the growth rate of government spending, reducing the tax rate to no more than 15%, and placing iron clad restrictions on IRS behavior and authority.

Thank you. I would be pleased to respond to your questions.

Big Government Hurts Economic Growth



The Economic Argument for a Flat Tax

Testimony to

The Joint Economic Committee

by

Laurence J. Kotlikoff

Professor of Economics, Boston University
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May 17, 1995

Senator Mack and Other Distinguished Members of The Joint Economic Committee:

I am honored by this opportunity to discuss with you the economics effects of a flat tax of the type originally proposed by Professors Robert Hall and Alvin Rabuska.

My testimony makes five points.

First, the flat tax, like other forms of consumption taxation, would be very good for the U.S. economy. Its adoption would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

Second, the predicted economic benefits from a flat tax are substantial. Generic simulations of shifting from income to consumption taxation in the standard neoclassical economic growth model -- the life-cycle model -- produce long-run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of a flat tax, although much more detailed simulation studies are needed.

Third, the flat tax, like other forms of consumption taxation, increases saving in large part by redistributing from older generations, with high propensities to consume, to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young and unborn, the flat tax would offset to a small degree the enormous past and ongoing reverse redistribution that has resulted from the expansion of pay-as-you-go entitlement programs and which is primarily responsible for the critically low level of U.S. saving.

Fourth, the flat tax is a much more progressive tax system than is generally believed to be the case. The reason is that consumption taxation, of which the flat tax is a form, represents the combination of wage taxation and wealth taxation. Since much of the inequality in living standards across members of each generation represents differences in the amounts of inherited wealth, the wealth tax component of the flat tax would enhance intragenerational equity.

Fifth, the U.S. economy needs consumption taxation. Whether consumption taxation should come in the form of a flat tax, a retail sales tax, a personal consumption tax, an Electronic Consumption Tax[1], or a value-added tax is a question that can provide hours of interesting debate. Each of the different

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[1] Under the Electronic Consumption Tax (the ECT), proposed in Kotlikoff (1995), households pass their ECT card through a card reader when they purchase goods and services. Montly purchases (but not the composition of purchases) are tallied and transmitted to the IRS, which withholds taxes. On April 15th, the IRS calculates consumption over the previous calender year, assesses taxes based on a progressive rate structure, and makes tax refunds or witholds additional taxes depending on whether total monthly withholdings in the prior calender year exceeds or falls short of the household's annual tax liability. Since the IRS' withholding of taxes and refunds of overpayments can be made electronically, the ECT entails no use of tax forms.

methods of taxing consumption has it advantages and disadvantages. But it will be a tragedy if we fail to adopt one of these methods of consumption taxation because we are locked in debate over which is the best one. In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation.

The Crisis in U.S. Saving

In 1950, the U.S. rate of net national saving was 12.3 percent. In 1994, it was only 3.5 percent. The difference in these saving rates is illustrative of a dramatic long-term decline in U.S. saving. The U.S. saving rate averaged 9.1 percent per year in the 1950s and 1960s, 8.5 percent in the 1970s, 4.7 percent in the 80s, and just 2.7 percent in the first five years of the 1990s.

The decline in U.S. saving has been associated with an equally dramatic decline in U.S. domestic investment. Since 1990, net domestic investment as a share of net national product has averaged 3.6 percent per year, compared with 8.2 percent in the 1950s, 7.9 percent in the 1960s and 1970s, and 6.1 percent in the 1980s.

The low rate of domestic investment has limited growth in labor productivity and, consequently, growth in real wages. Since 1980, labor productivity has grown at less than half the rate observed between 1950 and 1979, and total real compensation (wages plus fringe benefits) per hour has grown at only one-eighth its previously observed rate.

Understanding the Decline in Saving

Table 1 reports average values of the net national saving rate for the 1950s, 1960s, 1970s, and 1980s as well as the first five years of the 1990s. The table also reports rates of government and household consumption out of output. In addition, the table reports my preferred measure of private-sector saving, the *household saving rate*, which equals the share saved of the output left over to the household sector after the government has consumed.

As Table 1 indicates, government spending is not responsible for reducing the rate of national saving. Indeed, government spending in the 1990s has averaged just 21.0 percent of output -- as low a rate as any observed in the five periods. The rate of household consumption spending, on the other hand, rose from 69.9 percent of output in the 1950s to 78.6 percent in the early 1990s. This increased rate of household consumption was associated with a decline in the household saving rate from 11.5 percent in the 1950s to 3.2 percent in the 1990s.

Whose Consumption Has Risen?

If the driving force behind the decline in U.S. saving is an increase in the rate of household consumption, it's natural to ask whose consumption within the household sector has risen so rapidly? The answer is the elderly's. Tables 2 and 3 document this fact.[2] They show a remarkable increase in the relative

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[2] These tables come from Gokhale, Kotlikoff, and Sabelhaus (1995).

consumption of the elderly over four periods for which Consumer Expenditure Survey data are available. This increase is more pronounced if medical care is included in the measure of consumption, but the increase in the relative consumption of non medical goods and services is also striking.

As shown in Table 4, the striking increase in the relative consumption of the elderly has coincided with an equally remarkable increase in their relative resources.[3] Indeed, as described in Gokhale, Kotlikoff, and Sabelhaus (1995), the the postwar decline in U.S. saving can be traced to two factors: a) this redistribution of resources toward older generations, with high propensities to consume, from younger ones (including those not yet born), with low or zero propensities to consume and b) increases in the propensity of the elderly to consume.

Much of the redistribution to the elderly reflects the growth in Social Security, Medicare, and Medicaid benefits. The increase in the elderly's consumption propensities may also reflect government policy, namely the fact that government transfers to the elderly come in the form of annuities. In providing these annuities, which are, of course, indexed for inflation, the government has, in effect, told the elderly they needn't worry as much about over-consuming and running out of income.[4]

Implications of the U.S. Saving Decline for Evaluating the Flat Tax

The fact that the government's past and ongoing intergenerational redistribution appears to be the chief culprit for the decline in U.S. saving is worth bearing in mind in considering switching from the income tax to the flat tax. Such a switch would partially offset this process of taking from the young and unborn and giving to the old. It would do so by placing a somewhat higher tax burden on the initial elderly and a somewhat lower tax burden on younger and future generations. In switching tax structures (and thus redistributing from the elderly with high propensities to consume to the young and unborn with low or zero propensities to consume), the government can engineer a reduction in aggregate consumption and a concomitant rise in national saving. This redistributional or "income" effects is the key reason that consumption taxation, in general, and the flat tax, in particular, raises national saving.

Understanding Why the Flat Tax Taxes Consumption

To understand why the flat tax taxes consumption and to place it in perspective, it may help to consider briefly the different tax bases available to the government and how their taxation affects saving decisions. Let's start by considering a government that wants to tax all of output (national income) at a fixed rate τ. To

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3 The term "resources" refers to a generation's net worth plus the present values its future labor income, pension income, and Social Security, Medicare, and other transfer payments, less the present value of its future taxes.

4 In addition, the medical care annuities that the government provides through Medicare and Medicaid come in the form of in-kind consumption of medical goods and services which the elderly cannot help but consume.

do so, it can levy a tax at rate τ on output as it is sold by firms to the private sector. Alternatively, it can levy a tax at rate τ on the factors of production -- labor and capital -- as they receive the proceeds from the sale of output in the form of wage income and capital income. A third possibility is to tax income recipients when they use their income to purchase consumption goods or acquire assets, i.e., when they save. Since what is saved is invested (i.e., saving equals investment), our hypothetical government can also tax income by taxing consumption plus investment.

A little algebra helps clarify the equivalency of these four different ways of taxing output. If we let Y stand for aggregate output or income, Yl for aggregate labor income, Yk for aggregate capital income, C for aggregate consumption (including government consumption), S for aggregate saving, and I for aggregate investment, we have the following identities: $Y = Yl + Yk = C + S = C + I$. So taxing output Y at a flat rate, say τ, is equivalent to taxing both Yl and Yk at the rate τ, and both, in turn, are equivalent to taxing C plus S or C plus I at the rate τ.

But there is no requirement that governments tax all of output either directly, by taxing it when it is produced and sold, or indirectly, by taxing it when it is received as income or when it is used to purchase consumption or acquire assets (finance investment). Governments can, instead, choose to tax only a component of income. For example, they can choose to tax labor income, but not capital income. Or they can choose to tax only one use of income, say consumption, but not investment.

If a government chooses to tax consumption it can do so directly by taxing the purchase of consumption goods, or indirectly, either by 1) taxing income when it is received by individuals in the form of wage income and capital income, but allowing a deduction (or subtraction) for the saving these individuals do or by 2) taxing wage income at the personal level, taxing capital income at the business level (before it is paid out), but allowing a deduction at the business level for investment.

The equivalence of these ways of taxing consumption can be seen from our simple identity; Consumption C equals income Y minus investment S, but it also equals Yl plus the difference between Yk and I. This last point, that consumption equals Yl plus (Yk - I) indicates that flat tax is a consumption tax. Why? Because a flat tax taxes Yl by means of a personal wage tax, and it taxes Yk-I by means of a tax on business profits (revenues less the cost of intermediate inputs and wage payments, which is Yk) and a deduction for new investment (which is I).

Why Tax Consumption?

Given that governments can tax consumption directly or indirectly and that they can do so either with progressive or proportional tax rates, why would they want to tax only output that is consumed and exempt from taxation output that is save (invested)? The answer is that a consumption tax provides more incentive to save (invest) than does an income tax. As our identity $Y = C + S$ indicates, taxing output can be viewed as taxing saving as well as consumption. Now economists view saving, not as an end in itself, but as a means to finance future consumption. So by taxing consumption and saving, an income tax effectively taxes future consumption twice, once when households save funds for future consumption and once when they engage in that future consumption. Since current consumption is taxed only once (ignoring past taxes on saving because bygones are bygones), in deciding between consuming more now and saving for future consumption, an income tax provides an incentive, at any point in time, to consume more now and save less for the future.

In addition to providing better saving incentives, moving from an income to a consumption tax produces, as previously mentioned, an intergenerational redistribution away from older generations toward younger and future generations that also lowers aggregate consumption and raises national saving. The reason this intergenerational redistribution occurs is that older generations pay a larger share of consumption taxes than they do of income taxes. Under an income tax, elderly retirees pay tax on only their capital income, whereas under a consumption tax, they pay tax on all their consumption purchases. Since elderly retirees finance their consumption by spending not just capital income earned on their net worth, but also the net worth itself (the principal) as well as private and social security pension benefits, the consumption of the elderly, taken together, exceeds their capital income. Moreover, the consumption of the elderly is a larger share of aggregate consumption, than their capital income is as a share of aggregate taxable income. Consequently, a shift from taxing income (including the capital income of the elderly), to taxing consumption (including that of the elderly), places a relatively higher tax burden on the elderly.

Economists refer to the change in economic behavior, such as saving, that arise from a change in one's resource position as ***income effects***. They refer to changes in economic behavior due to changes in incentives, holding resources constant, as ***substitution effects***. The above discussion indicates that the substitution and income effects of moving from income taxation to consumption taxation reinforce one another. Both work in favor of lowering aggregate consumption and raising national saving.

Why Consumption Taxation Represents a Combination of Wage and Wealth Taxation

The income effects from consumption taxation arise, in large part, because the consumption tax represents a combination of a tax on wages and a tax on wealth.[5] The reason is that the consumption goods and services that households purchase over time are ultimately financed by the wages they earn plus their initial wealth. Consider, for example, a millionaire who doesn't work, but spends his

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[5] To see this algebraically, note that at time t, $Ct = Ylt + Ykt - St$. But, if we let Wt stand for wealth at time t, then $Ykt = rtWt$, where rt is the rate of return earned on wealth (i.e., $rtWt$ equals capital income). Also, $St = Wt+1 - Wt$. Hence, $Ct = Ylt + rtWt - Wt+1 + Wt$. Write this equation out for time t+1, t+2, etc., and then use the t+1 equation to substitute out for $Wt+1$ in the time t equation, to get a new time t equation that will depend on $Wt+2$. Next use the time t+2 equation to substitute out for $Wt+2$ in the new time t equation. Proceding in this manner leads to an equation in which the present value of consumption equals the present value of current plus future labor earnings plus initial wealth. Multiplying each side of this present value budget constraint by the tax rate t shows that taxing consumption through time at rate τ is equivalent to taxing earnings through time at rate τ plus taxing initial (time t) wealth at rate τ.

wealth on consumption. In the case of a direct consumption tax, such as a retail sales tax, the millionaire pays tax as he spends down his wealth; hence, the consumption tax effectively taxes his wealth. Now suppose the millionaire also works. Then when he spends his wage earnings, he also pays consumption taxes, so the consumption tax also effectively taxes wage earnings. If the millionaire chooses not to consume and passes his wealth to his heirs, they will be taxed when they spend their inherited wealth.

Since, as just mentioned, the elderly have a disproportionately large share of wealth, a switch from income to consumption taxation places a relatively large share of the tax burden on them. Although the consumption tax also, in effect, taxes wage income, which is also taxed under the income tax, it does so at a lower rate than under the income tax because the consumption tax gets more revenue from the wealth tax component. Hence, the young, who are disproportionately larger earners of labor income, benefit from the shift from income to consumption taxation because their effective rate of wage taxation is reduced.

The reduction in the effective rate of wage taxation stimulates labor supply, thereby raising output and further increasing aggregate saving. This stimulus to labor supply will be even greater if the switch in tax structures is from a progressive income tax to a consumption tax. Why? Because the incentive to work depends on the marginal rate of taxation of labor supply, not the average rate. Under progressive income taxation, the marginal effective rate of taxation of labor supply is higher than under a proportional income tax, which is higher still than under a consumption tax.

Understanding How the Flat Tax Taxes Wealth

The flat tax, at least the one originally designed by Hall and Rabushka, encompasses a one time effective tax on real wealth. Under the flat tax, as under our current income tax structure, the sale, by businesses (really, by the owners of businesses), of their real assets (their plant, equipment, and inventories) is included in the calculation of business revenues and is subject to tax. But, unlike the current tax structure, the flat tax permits no deduction of the basis of the asset when it is sold. If the basis of the asset could be deducted, the flat tax, like our current income taxation of businesses, would be taxing simply the capital gains realized by businesses on the sale of their real assets. Why? Because capital gains are calculated as the difference between the sale price of the asset and its depreciated tax basis.

Can owners of real assets avoid the additional tax arising from not being able to deduct basis by simply not selling their asset, but instead, continue to use them to produce business income? The answer is no. The market value of real assets will fall to the point that the owners of the assets will be indifferent between retaining and selling their assets. This decline in the market value of existing real wealth (which will be registered on the stock market) represents an effective tax on real wealth.

To understand why the market value of real business assets must fall, consider an investor, ABC Co., which is considering purchasing a newly produced real asset, say a drill press, for $1000 or buying an existing business, DEF Co., with, for simplicity, a single asset -- an identical drill press which it had purchased prior to the switch to the flat tax and which has a basis of $1000. Assume, for simplicity, that drill presses do not physically depreciate, so the two machines are physically identical. If ABC purchases the new drill press, it can immediately expense it (deduct its purchase price from its business income). If the flat tax rate is 20 percent, the value of the write off is $200. If ABC purchases DEF, it acquires the same machine, but can't expense it. Consequently, the market value of DEF must fall until ABC and other potential investors are indifferent between purchasing DEF directly and purchasing the same real asset owned by DEF, but expensing it. Hence, the market value of DEF will be $800.

Now, if ABC purchases and then liquidates DEF, it will be to sell DEF's drill press on the market for $1000, because the new owner can treat the press as a new asset and expense it. But in selling the drill press, ABC will produce $1000 in sales revenues for its subsidiary, DEF, and, thus, a $200 tax liability. Hence, in liquidating DEF, ABC will end up with $800. So whether ABC buys DEF to hold it or to liquidate it, the most it will pay is $800. If it tries to buy DEF for less than $800, the owners of DEF will refuse, because they will be able to find other buyers willing to pay $800. Hence, the market price of DEF will be $800.

The Importance of Implicit Wealth Taxation

Note that if the flat tax is modified from the original Hall/Rabuskha proposal, which taxed, at the business level, all sale proceeds (including sale of old capital) less purchases from firms (including purchases of new capita) and wages, to one which allows firms to deduct the basis in their old capital when it is sold, the outcome will be quite different. Now the sale of old capital will engender a tax on the sale proceeds, but be accompanied by a deduction of the basis of equal value, so that, in effect, only the capital gain on the old capital is being taxed. In this case, in which there is a very strong incentive to sell old capital to new owners who can deduct it, the market value of old capital doesn't fall and, consequently, the effective taxation of wealth does not arise. Without this effective taxation of wealth, the flat tax produces a much smaller reduction of consumption and, consequently, a much small increase in aggregate saving.

Indeed, devoid of its effective taxation of wealth, a flat tax or any other "consumption tax" simply ends up taxing wages. Note that the switch from income to wage taxation redistributes from the young to the old, since the elderly have relatively little wage income, but benefit from the elimination of capital income taxation. Although a wage tax structure provides better incentives to save, its income effects work to reduce saving. Indeed, the net impact, according to simulation studies (see Auerbach and Kotlikoff, 1987) of a switch from income to wage taxation is a relatively modest increase in aggregate saving, investment, and output. It follows that permitting firms to deduct the basis of their old capital at the time it is sold greatly undermines the case for the flat tax.

The Size of Implicit Wealth Taxes and the Impact on Interest Rates

The precise extent to which the market value of old capital may decline as the result of implementing the original Hall-Rabushka flat tax proposal depends on a number of factors. One of these is the size of the current basis of the asset.

Since the deduction of basis is being precluded, the larger an asset's basis, the larger will be the decline in its market value. A second factor is the rate of taxation that will prevail under the flat tax. The lower this rate, the smaller will be the advantage of expensing new capital and, consequently, the smaller will be the market discount of old capital. A third factor is the extent of costs of adjusting the level of business capital stocks. If these costs are high and investment is positive, old capital will, other things equal, sell at a premium, relative to new capital for the simple reason that it is already installed; i.e., business do not need to install old capital (and incur adjustment costs) in order to use it in production.

In addition to lowering the market value of old capital and, thus, the market value of equity (the price of stocks), the flat tax may reduce the market value of existing debt (the price of bonds). The depends, in part, on monetary policy and, in part, on what happens to interest rates. If the money supply is not increased beyond what would otherwise have been the case, we should see no additional rise in the price level associated with the introduction of the flat tax and, consequently, no watering down of the real value of outstanding nominal debts.

In the case of interest rates, a rise in which would lower bond prices, there are at least four important factors at play. First, the increase in investment induced by the shift to the flat tax would, over time, raise the stock of capital above levels that would otherwise prevail. These higher levels of capital will raise the productivity of labor, but lower that of capital. This factor will depress interest rates, primarily medium and long-term interest rates. The second factor is the reduction in the rate of business taxation which means that companies will be able to pay a higher return to their lenders. This factor will serve to raise short- as well as medium- and long-term interest rates. The third factor is the elimination of business' ability to deduct interest payments. This factor will reduce short-, medium-, and long-term interest rates because it will limit the amount of after-tax income firms can pay their lenders. The fourth factor is the ability of firms to expense their investment. This tax saving represents another source of after-tax income that firms can pay their lenders (and will be forced, by competition, to pay their lenders). This factor will serve to raise short-, medium-, and long-term interest rates.

What will be the net impact of these four factors on interest rates? It's hard to give a precise answer without some more detailed analysis, but my sense is that interest rates will, on balance, rise as the result of introducing the flat tax, although probably not by more than 100 basis points.

The flat tax is also likely to produce a decline in the market value of housing. The reason is that, under the flat tax, the consumption of housing services will no longer be tax-favored as it is under the income tax. Under the income tax, the implicit rental income that homeowners earn by living in their homes escapes taxation because the government does not impute and add this income to homeowners' adjusted gross incomes prior to assessing their income taxes (i.e., this form of capital income escapes income taxation). Under the flat tax, personal capital income taxation is eliminated, so the receipt of imputed rent on owner-occupied housing is no longer tax-favored relative to the receipt of other forms of capital income. Although the flat tax will not alter the market value of newly built versus old homes, it will make home ownership relatively less advantageous than other forms of consumption. Consequently, the demand for homes will decline and this will, in the short run, put downward pressure on house values given that the existing supply of homes cannot costly be reduced, at least in the short run.

Efficiency Gains from Consumption Taxation

The current tax system contains a number of distortions which also could be eliminated by switching to the flat tax or other forms of consumption taxation. One of these distortions is the differential tax treatment of corporate and noncorporate business that distort business ownership and control decisions. A second is the differential tax treatment of capital gains and dividends that distort firms' decisions about retaining earnings and that lock investors in from selling shares of stock which have accrued capital gains. A third is the aforementioned implicit subsidy to home ownership, as well as automobiles, and other durable goods that arises from our failure to tax, under the income tax, the rental income we implicitly earn from the services on these durables.[6] A fourth is the subsidization of current relative to future consumption (the tax on saving) associated with the taxation of capital income. A fifth is the differential tax treatment of investment in equipment, structures, and inventories. A sixth is the distortion in corporate financial structure due to the deductibility of interest payments, but the nondeductibility of dividends. And an seventh is the subsidization of health insurance premia and other fringe benefits that are currently exempt from income taxation, but would be treated like wage compensation under most consumption tax proposals.

The distortion of labor supply incentives associated with income taxation would also be eliminated by the proposed tax shift. But a consumption tax would distort this margin of choice as well, so one needs to compare the efficiency gains from eliminating the income tax's distortion of labor supply with the efficiency loss from adding the consumption tax's distortion of labor supply. There is good reason, however, to expect the tax shift to result in a net reduction in the distortion of labor supply. The reason, as mentioned above, is that consumption taxation will extract a larger share of its revenues from older generations, many of whom are retired. As a result, the total tax that needs to be collected from working generations is smaller under a consumption tax than it is under the income tax.

The distortion of labor supply will also be substantially reduced if our progressive income tax rate is replaced by the flat tax because the flat tax will leave most workers facing significantly lower total effective marginal tax rates on their labor supply than is currently the case. The size of economic distortions of particular economic activities rises with the square of the total effective marginal tax rate on that activity. In the case of labor supply, most Americans face marginal taxes above 50 percent on their earnings once one adds together the effects of all the different tax and transfer programs at the federal, state, and local government levels. This is an extremely high level of marginal taxation, which is highly distortive. The flat tax's reduction in this rate of taxation, like that of other

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6 To see this, suppose homeowners, owners of automobiles, and owners of other durables were forced to pay rent to themselves for their use of their homes, cars, furniture, etc. At one level, this would be a wash, since the person writing the check would also be the recipient of the check. But this requirement would raise households' taxable income, leading them to pay more income taxes. Does it make sense to think of, say, a home owner as renting her house to herself? The answer is yes since in occupying her house, the home owner is effectively earning the rent on the house and then spending it on herself.

proportional consumption taxes, represents a very strong argument for its adoption, indeed.

The Auerbach-Kotlikoff Dynamic Life Cycle Simulation Model[7]

The Auerbach-Kotlikoff Model (henceforth, the AK model) can provide some sense of the potential saving, investment, and growth effects of shifting to a proportional consumption tax, such as the flat tax.[8] The AK model calculates the time-path of all economic variables in its economy over a 150 year period. The model has 55 overlapping generations. Each adult agent in the model lives for 55 years (from age 20 to age 75).

There are three sectors in the model: households, firms, and the government. Households (adult agents) make decisions concerning how much to work and how much to save based on the after-tax wages and after-tax rates of return they can earn in the present and the future on their labor supply and saving, respectively. The work decision involves not only deciding how much to work in those years that one is working, but also when to retire. The AK model's particular form of consumption and leisure preferences that agents use in making their labor supply and saving decisions were chosen in light of evidence on actual labor supply and saving behavior.5

As agents age in the model, they experience a realistic profile of increases in wages. This age-wage profile is separate from the general level of wages, the time-path of which is determined in solving the model. Fiscal policies affect households by altering their after-tax wages, their after-tax rates of return, and, in the case of consumption taxes, their after-tax prices of goods and services. The model is equipped to deal with income taxes, wage taxes, capital income taxes, and consumption taxes. It is also able to handle progressive as well as proportional tax rates.

All agents are assumed to have the same preferences, so differences in behavior across agents arise solely from differences in economic opportunities. Since all agents within an age cohort are assumed to be identical, differences in economic opportunities are present only across cohorts. In this study, the model's population growth rate is set at a constant 1 percent rate, with the population of each new cohort being 1 percent larger than that of the previous cohort.

The AK Model's production sector is characterized by perfectly competitive firms that hire labor and capital to maximize their profits. The production relationships that underlie firms' hiring decisions and production of output are based on

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[7] This section presents the results reported in Kotlikoff (1992) of simulations of a switch from federal income taxation to a retail sales tax. Because a retail sales tax is equivalent to a flat tax of the type originally proposed by Hall and Rabushka, the simulation findings apply to the flat tax as well. The simulations are highly stylized. They do not, for example, take into account proposed exemptions from taxation as well as a number of other features of the flat tax proposals recently advanced by Congressman Armey and Senator Specter.

[8] For a detailed description of the AK Model see Auerbach and Kotlikoff (1987).

empirical findings for the U.S. The government sector consists of a treasury that collects resources from the private sector to finance government consumption and an unfunded, "pay as you go" Social Security system which levies payroll taxes to pay for contemporaneous retiree benefit payments. The model does not distinguish federal from state and local government. Hence, in simulating with the model the elimination of income taxation in favor of consumption taxation, we will, in effect, replace all state and local income taxes, as well as federal income taxes, with a federal consumption tax which can be thought of as a federal flat tax. There is no money in the model, and thus, no monetary policy. There is, however, government debt, and the model can handle deficit-financed tax cuts. It can also handle gradual phase-ins of one tax for the other.

While the model handles a great number of complex processes, its predictions need to be viewed cautiously for several reasons. First, the model does not deal with several of the real world distortions associated with the income tax that were mentioned above. For example, it doesn't distinguish corporate from noncorporate production, housing consumption from non housing consumption, different forms of corporate finance, different types of investment, or differences in capital gains and dividend tax rates. Nor does it permit the kind of tax arbitrage that is available to most tax-paying Americans through tax-subsidized saving accounts. Second, the model's agents are heterogeneous only with respect to their age. There are no welfare recipients or millionaires, whose saving and work behavior might differ dramatically from that of the model's agents. Third, the model does not include saving for purposes other than retirement, such as bequests. Fourth, the model does not incorporate uncertainty either with respect to individual or macroeconomic outcomes. Fifth, the model ignores illegal tax avoidance, an issue that would certainly arise in implementing a flat tax or any other form of consumption taxation. While the model abstracts from a significant portion of reality, it can, nonetheless, suggest the degree to which a switch from consumption taxation to income taxation might raise U.S. national saving.

Simulating the Switch from Proportional Income to Proportional Consumption Taxation

In simulating the switch from income taxation to a federal consumption tax, one needs to specify the economy's initial position as well as the way the tax change takes place. To begin, let's assume that the economy has a 15 percent proportional income tax and a 17 percent sales tax. The 15 income tax figure is based on the 1991 ratio of the sum of federal, state, and local personal and corporate income taxes to net national product. The 17 percent sales tax figure is based on the 1991 ratio of the sum of federal, state, and local sales and excise taxes to total personal consumption.6 These taxes are used to finance government consumption spending as well as pay interest on the government debt. The level of government debt is set at 50 percent of output.7 In addition to these features of fiscal policy, the economy is assumed to have a "pay-as-you-go" social security system with a 15 percent payroll tax rates.

Findings

Table 5 shows the transition-path of the economy that results from replacing in year 0 the model's income tax with a proportional consumption tax. I set the new federal consumption tax rate (the flat tax rate) at the level needed, in conjunction with the pre-existing 17 percent sales tax, to continue to finance the same level of government spending as well as pay interest on the stock of government debt. The first row in the table indicates the economy's initial (year 0) position. With no change in tax policy the economy would remain in this position through time. I measure annual saving rates, annual interest rates, and tax rates in percentage points. In the case of our economy's other variables, the units of measurement are arbitrary, so I describe each of these variables in terms of an index which has an initial (base-year) value of 100.

The initial position of the economy features a 2.6 percent saving rate, a per capita capital stock of 100, a per capita labor supply of 100, a level of per capita output of 100, a real wage rate of 100, a real interest rate of 9.4 percent and, of course, a zero federal consumption tax rate. The 2.6 percent saving rate is close to the current U.S. rate of saving, and the 9.4 percent real interest rate is close to the annual real rate of return that has been earned, on average, on the U.S. capital stock in the postwar period.

The remaining rows in Table 5 show how each of these variables reacts to the introduction at time 0 of the federal consumption tax. As row 1 indicates, the tax change produces an immediate and dramatic increase in the economy's saving rate from 2.6 percent to 9.0 percent. While the saving rate gradually declines after year 1, it remains above 6 percent through the tenth year of the transition. The long-run (year 150) value of the saving rate is 3.2 percent -- 23 percent larger than the year 0 value.

The increased saving produces a concomitant increase in investment. As a result, the capital stock rises. Indeed, the switch in tax regimes leads, eventually (by year 150), to a 34 percent increase in the per capita capital stock. The increase in the capital stock is gradual; only about one quarter of the ultimate increase occurs in the first 10 years of the transition. The increase in the capital stock raises the productivity of workers and thus their real wage. The policy also lowers the return to capital. The real interest rate falls by almost 200 basis points in the course of the transition.

While the real wage ultimately ends up 7 percent higher than it would have been without the tax change, for the first few years of the transition the real wage actually falls. The reason is that agents respond to the prospect of higher real wages and higher short-term real interest rates by increasing their labor supply. In the short run, before the capital stock has had much of a chance to increase, there is an increase in the supply of labor relative to the supply of capital. As a result, labor in the first few years of the transition becomes relatively abundant, meaning that the price it receives in the market -- the real wage -- falls. Eventually, as interest rates fall, the incentive to work more in order to save more and receive higher rates of return on the additional savings diminishes. As a result, labor supply declines. In the long run, the supply of labor is only one percent greater than it is in year 0.

The changes in the supplies of capital and labor alter the per capita level of output. Between year zero and year 1, there is a 4 percent increase in output. In the following 10 or so years the switch in the tax structure raises the economy's growth rate by two tenths of one percent per year. In the long-run, the level of per capita output is 8 percent larger than it is at time 0.

The final variable to discuss is the consumption tax rate. The year 1 value of this tax rate is 23.1 percent. But it declines through time, with its value in the long-run ending up at 16.7 percent. The reason the tax rate can decline is that the growth of the economy permits a higher level of consumption and thus produces a higher consumption tax base. In addition, the reduction in the interest rate lowers required interest payments on the government's debt.

To summarize the findings in Table 5, the simulation of a switch to a federal consumption tax produces a significant increase in saving, capital accumulation, the real wage, and the level of per capita income. While the dynamics are nonlinear (e.g., labor supply first rises and then falls), all of the results make intuitive sense.

Maintaining a Constant Consumption Tax Rate

As an alternative to having the consumption tax rate decline through time, we might want to have a tax rate that is constant through time. I've used the model to simulate such a policy. I've found that if I set the tax rate equal to 19 percent, the model produces deficits in the short-run, since the additional tax revenue raised with the 19 percent tax falls short of the loss in revenue from eliminating the 15 percent income tax. But over time, the growth of output and the consumption tax base associated with the reform raises the amount of revenue collected by the 19 percent tax permitting the full retirement of the additional debt that is issued in the short-run. In this constant tax rate simulation the long-run capital stock and output levels are 32 percent and 7 percent higher than their respective year 0 values. These long-run percentage increases may be compared with the 34 percent and 8 percent increases of Table 5.

Are the Results Reasonable?

Given the size of the model's predicted response to a switch to a consumption tax, one might ask whether the results are really plausible or whether they simply reflect some extreme assumptions about labor supply and saving behavior. The answer is that the labor supply and saving responses assumed in the model are quite conservative. They are certainly well within the range of responses that have been estimated in the empirical economics literature. In addition, the life cycle model being simulated is the basic bread and butter model of neoclassical economics.8

There is, however, one feature of the model which may make the transition occur faster in the model than it would in the real world. This is the model's assumption that new capital can be immediately added to the existing stock of capital without the incursion of installation costs. As discussed in Auerbach and Kotlikoff (1987), the addition of such installation costs would slow down the transition, but would not alter the size of the long-run change of any of the economy's variables.

Another issue, with which I have not yet dealt, is the progressivity of the income tax which is to be replaced. As mentioned, the AK model can handle progressive as well as proportional tax rates. In the case of a progressive income tax, whose degree of progressivity is roughly comparable to that now in the U.S., the year 0 position of the economy from which the transition begins is one featuring a 2.2 percent, rather than a 2.6 percent, saving rate, a per capita capital stock that is 18.1 percent smaller, a per capita labor supply that is 5.2 percent smaller, a per capita output level that is 8.6 percent smaller, a real wage that is 3.5 percent smaller, and an interest rate of 10.4 percent rather than 9.4 percent. Since the switch from this progressive income tax regime to a proportional consumption tax produces the same long-run outcome as indicated in the last row of Table 6, the saving, capital accumulation, and growth effects of the tax change are all magnified by assuming that the initial income tax is progressive. For example, the long-run increase in the per capita capital stock is 63.4 percent, and the long-run increase in per capita output is 18.3 percent.[9]

The Impact on the Initial Elderly

While switching to a consumption tax has a lot to recommend it, this does not include the treatment of the initially elderly who, as mentioned, end up paying much more in consumption taxes than they would have paid in income taxes. For example, in the simulation of Table 5, the oldest elderly in year 1, those who are age 55, suffer a 23 percent decline in their final year's consumption. There are different ways to avoid, or at least mitigate, this redistribution away from those who are old at the time of the switch in tax structures. One is to make additional transfer payments to the initial elderly by, for example, raising social security benefits. The problem with making transfer payments to the initial elderly is that these transfer payments will lead them to consume more and this additional consumption will limit the increase in saving and capital accumulation.

Table 6 points this out. It shows the transition arising from an immediate switch to a retail sale tax, but one in which the government makes transfer payments to all generations alive at the time of the transition to ensure that none of these generations is made worse off from the tax switch. These transfer payments are, of course, largest for the oldest generations alive at the time of the tax switch, since they do not benefit as much from the elimination of income taxes as do younger generations. While the provision of this compensation to initial generations limits the additional saving generated by the consumption tax, there remains, nonetheless, a substantial saving response. According to Table 6, there is a 22 percent increase in the economy's long-run capital stock. While this is less than the 34 percent increase of Table 5, it is still quite substantial. With the compensation scheme in place, the long-run increase in per capita income is 6 percent (compared with 8 percent with no compensation). The fact that one can compensate initial generations in switching to a federal consumption tax and still make future generations significantly better off is reflective of the inefficiency of an income tax structure relative to a consumption tax structure.

Summary and Conclusion

Our nation is facing a grave crisis with respect to its rate of saving. We are saving at record low levels, and unless we start saving more, we will continue our slide

[9] Interestingly, as described in Auerbach and Kotlikoff (1987), almost the same final steady state arises if the switch is to a progressive consumption tax.

toward second-class economic status. A shift to consumption taxation, be in the form of a flat tax, a retail sales tax, a value-added tax, the Electronic Consumption Tax, or a personal consumption tax, has the potential for dramatically increasing our saving rate. It would do so by improving incentives to save and redistributing from the elderly with high propensities to consume to young and future generations with low or zero propensities to consume.

In addition to raising saving and investment, consumption taxation would reduce many of the distortions of the current tax system. Indeed, the distortion of saving behavior alone is so great under our current system of income taxation that it appears we could switch to consumption taxation, fully compensate the initial elderly for their higher tax burden, and still end up with a much higher rate of saving, capital accumulation, and level of per capita income.

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Table 1

Saving and Spending Rates

Period	Net National Saving Rate (Y-C-G)/Y	Government Spending Rate G/Y	Household Consumption Rate C/Y	Household Saving Rate (Y-G-C)/(Y-G)
1950-59	.091	.210	.699	.115
1960-69	.091	.221	.688	.117
1970-79	.085	.214	.701	.108
1980-89	.047	.213	.740	.059
1990-94	.027	.207	.766	.031

Y stands for net national product, C stands for household consumption expenditure, and G stands for government purchases of goods and services.

Table 2

Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.17	1.37	1.58	1.59
Age 70/Age 20	0.97	1.21	1.56	1.64
Age 80/Age 20	0.89	1.16	1.61	1.60
Age 60/Age 30	0.86	0.93	1.09	1.15
Age 70/Age 30	0.71	0.82	1.07	1.18
Age 80/Age 30	0.65	0.79	1.11	1.16
Age 60/Age 40	0.77	0.83	0.87	0.91
Age 70/Age 40	0.64	0.73	0.86	0.94
Age 80/Age 40	0.58	0.70	0.89	0.92

Source: Gokhale, Kotlikoff, and Sabelhaus (1995).

Table 3

Non Medical Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.11	1.28	1.43	1.42
Age 70/Age 20	0.86	1.04	1.22	1.28
Age 80/Age 20	0.75	0.91	1.16	1.11
Age 60/Age 30	0.81	0.86	0.97	1.02
Age 70/Age 30	0.63	0.70	0.83	0.91
Age 80/Age 30	0.55	0.61	0.78	0.80
Age 60/Age 40	0.73	0.78	0.77	0.80
Age 70/Age 40	0.57	0.63	0.66	0.72
Age 80/Age 40	0.49	0.55	0.62	0.63

Source: Gokhale, Kotlikoff, and Sabelhaus (1995)

Table 4

Resources[a] of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.10	1.41	1.72	1.81
Age 70/Age 20	0.85	1.14	1.49	1.58
Age 80/Age 20	0.63	0.71	0.76	0.83
Age 60/Age 30	0.92	1.07	1.26	1.31
Age 70/Age 30	0.72	0.86	1.09	1.15
Age 80/Age 30	0.53	0.54	0.56	0.60
Age 60/Age 40	0.82	0.95	1.05	1.10
Age 70/Age 40	0.64	0.77	0.91	0.96
Age 80/Age 40	0.47	0.48	0.47	0.51

[a]Resources refers to net worth plus the present values of future labor income, private and government pension benefits, and government transfer payments less the present value of government taxes.
Source: Gokhale, Kotlikoff, and Sabelhaus (1995)

Table 5

Simulating An Immediate Switch From Income Taxation to a Consumption Tax

Year	Saving Rate	Capital[a] Stock Index	Labor[a] Supply Index	Output[a] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	9.0	100	105	104	99	9.7	23.1
2	8.5	102	105	104	99	9.6	22.5
3	8.1	105	105	105	100	9.4	21.9
4	7.8	107	105	105	100	9.2	21.5
5	7.5	109	104	105	101	9.1	21.1
.							
10	6.2	117	103	106	103	8.5	19.5
20	4.5	127	101	107	106	7.9	17.9
.							
60	3.7	131	101	108	107	7.8	17.3
.							
90	3.2	134	101	108	107	7.5	16.8
.							
150[b]	3.2	134	101	108	107	7.5	16.7

a The capital stock, labor supply, and output are per capita measures.
b Year 150 represents the economy's final steady state.

Table 6

Simulating An Immediate Switch From Income Taxation to a Consumption Tax But Compensating Initial Elderly for their Increased Tax Burden

Year	Saving Rate	Capital[a] Stock Index	Labor[a] Supply Index	Output[a] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	6.6	100	104	103	99	9.7	22.1
2	6.4	101	104	104	99	9.5	21.8
3	6.3	103	104	104	100	9.4	21.5
4	6.1	104	104	104	100	9.3	21.2
5	5.9	106	104	104	100	9.2	21.0
.							
10	5.1	111	103	105	102	8.8	19.9
.							
20	4.1	118	102	106	104	8.4	18.7
.							
60	3.0	122	101	106	105	8.1	17.8
.							
90	3.0	122	101	106	105	8.1	17.8
.							
150[b]	3.0	122	101	106	105	8.1	17.8

a The capital stock, labor supply, and output are measured per capita.
b Year 150 represents the economy's steady state.

Time to Rethink the Income Tax

An Overview of the Flat Tax

Prepared by the staff of the
Joint Economic Committee

Senator Connie Mack, Chairman

Time to Rethink the Income Tax
An Overview of the Flat Tax

What is a Flat Tax?

A flat tax system would levy only one tax rate on all income subject to tax. Income would be taxed once and only once. The complexity and unfairness produced by hundreds of tax exemptions, credits, loopholes and deductions now prevalent in the current tax system would be removed so that the lowest single tax rate could be levied. Only a personal allowance and dependent deduction would be subtracted from income before it is taxed.

Can A Flat Tax Be Revenue Neutral?

Yes. Any flat tax system can be designed to bring in exactly the same amount of revenues to the U.S. Treasury as the existing federal income tax to make it revenue neutral. The tax rate that will result in revenue neutrality depends on the allowances (deductions) that are permitted. In other words, there is a direct tradeoff between the amount of deductions and the tax rate. The higher the allowances are set, the higher the tax rate would need to be in order to bring in the same amount of tax revenue as the current system.

The chart below shows a hypothetical set of tax rates and allowances produced by the Congressional Budget Office (CBO) that would result in a revenue neutral flat tax system. CBO's tax simulation model shows that all federal income tax revenues could be fully replaced by a flat tax system with a tax rate of 13.1 percent and no deductions. Allowing total family deductions to reach $36,800 (well more than double the amount allowed in 1995) would require a 19.9 percent tax rate.

Revenue Neutral Tax Rates for Alternative Allowances and Exemptions under a Flat Tax

	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Standard Allowances					
Single	$13,100	$13,100	$6,550	$6,550	$0
Joint	$26,200	$26,200	$13,100	$13,100	$0
Head of Household	$17,200	$17,200	$8,600	$8,600	$0
Dependent Exemption	$5,300	$2,650	$5,300	$2,650	$0
Revenue Neutral Rate	19.9%	19.4%	16.8%	16.3%	13.1%

Source: the Congressional Budget Office 1995

A Tax System Gone Awry

There is a large and growing consensus among economists, lawmakers, and typical taxpayers that our current income tax system has become a tremendous obstacle to economic growth and our standard of living. After eight decades of misuse by lawmakers, lobbyists, special interests, and income redistributors, our tax system is unfair, complex, costly, and punishes work effort, savings and investment. Simply stated, our onerous income tax system is unfit to carry us into the 21st century and prevents us from insuring a better future for ourselves, our children and grandchildren.

Since its 1913 enactment, our income tax system has fallen prey to a multitude of unintended purposes--including income redistribution, social engineering, and government micro-management of our saving, investing, and spending decisions.

The purpose of any tax should simply be to provide revenue to cover the cost of government. A tax system should allow taxpayers to clearly see the cost of government spending and thereby enable them to determine how much government they are willing to pay for. Unfortunately, since its 1913 enactment, our income tax system has fallen prey to a multitude of unintended purposes--income redistribution, social engineering, and government micro-management of our saving, investing, and spending decisions.

As a democracy, we have the right to demand that our tax system be equitable, efficient, and supportive of our nation's greatest economic growth potential. Sadly, our current tax system treats individuals unfairly, exacts tremendous administration and compliance costs, and hinders the full productive potential of our economy. As a result, every American's potential for a higher standard of living is jeopardized.

New Thinking Required

Mere tinkering cannot suffice to correct the enormous problems ingrained within our current tax system. Partial reforms have been tried repeatedly in the past with only limited success at best. Therefore, we need to fundamentally rethink the manner in which income is taxed in order to construct a system that is equitable, efficient, and supportive of economic growth. In order to achieve genuine tax reform, the blinders must be taken off, special interests must give way to overriding national concerns, the politically motivated "rich vs. poor" class warfare that has restrained everyone must stop, and the defenders of the status quo must allow positive change.

The flat tax reform plan, pioneered by Professors Robert Hall and Alvin Rabushka of Stanford University, encompasses the new thinking and fundamental change that is needed to create a fair, simple, and pro-growth tax system.

Why Do We Need A Flat Tax?

Problem. Our current tax system is **unfair**, often levying different tax burdens on people with the same income. For example, higher taxes are levied on some senior citizens' with Social Security income. Additionally, our current tax system allows only certain people to take advantage of special tax loopholes and tax breaks while forcing others to pay higher taxes.

Solution. The flat tax, with its one low tax rate, would insure that **all taxpayers pay their share**. Tax breaks for special interests would be eliminated. The flat tax would provide fundamental fairness for all taxpayers.

Problem. Our current tax system is needlessly **confusing and complex**. It takes Americans six billion hours each year, at a cost of $200 billion just to comply with the tax code.

Solution. The flat tax **eliminates confusion and complexity** by replacing hundreds of deductions and multiple tax rates with one low tax rate. Taxes can be filed on a form the size of a post card and every taxpayer can clearly see exactly how much income tax they are paying. The wasteful cost of complying with taxes would be reduced tremendously for individuals, and government. And this savings could be used to lower the tax burden.

Problem. The current tax code **punishes people who work hard or take risks** to improve their standard of living. Currently, people automatically have to forfeit more of their money to taxes when they increase their income and are pushed into higher tax brackets--cutting Uncle Sam in on a larger share of their hard work. Our current system has steep increases in tax rates that crush work and entrepreneurial efforts so vital to improving our standard of living. Because of our high tax rates, people have been working longer and harder with little to show for it.

Solution. The flat tax would not punish hard work and success. Even under the flat tax, the more you make the more you pay. However, under the flat tax, **Uncle Sam would not demand a disproportionately larger, punitive percentage of your income as you earn more**.

Problem. The current tax code **discourages saving and investing** by taxing these activities more than once. This makes it much more attractive and rewarding to consume rather than save. As a result, there is insufficient savings and investment needed for economic growth and the full productive potential of our economy is eroded. Therefore, every American's potential for a bigger incomes and improved standard of living is diminished.

Solution. The flat tax **eliminates double and triple taxation**. Everyone, regardless of how they earned their income, would pay income taxes when their income is earned. However, if you then decide to save or invest this after-tax income, your returns (interest and dividends) would not be taxed yet again. Everyone, except for the lowest income groups, would pay taxes on their income, but they would pay once and only once at a single low rate. Unlike the current system, people who save and invest for their future would not be punished with higher taxes under the flat tax. And, unlike the current tax system, under the flat tax individuals could no longer avoid paying taxes by taking advantage of special deductions.

Problem. The current tax code's high rates and multitude of deductions **force investment**

decisions to be based on tax consequences instead of economic merit alone; this stifles economic growth.

Solution. A low rate flat tax **would eliminate special-interest subsidies, loopholes, or tax shelters**, allowing investment decisions to be made based on their economic merit, not on their tax consequences. Investment in unproductive tax shelters would shift to more productive endeavors and economic growth would improve.

Problem. The current tax code **allows government to micro-manage peoples' behavior**–jeopardizing their individual liberty and their freedom to decide how best to use their own money. Currently, Uncle Sam takes a huge chunk of people's income and then bribes them with their own money by giving some of it back with a deduction here or a credit there.

Solution. A low-rate flat tax would **allow taxpayers to keep more of their own money as they earn it**. Allowing everyone to keep more of their hard-earned money up front would prevent people from being at the mercy of the changing whims of Uncle Sam. Simply stated, if individuals are given the lowest tax rate possible under a flat tax, the need for special deductions would be eliminated.

Problem. **Tax rates are too high**. Marginal income tax rates that were set at 15 and 28 percent just a few years ago now are as high as 45 percent. High marginal tax rates damage economic growth by reducing the incentive to work, save, and invest. Marginal tax rates have a major impact on whether people devote their time to working or staying home, investing or seeking tax shelter, and investing in their future or spending their money now.

Solution. Under a single, low rate flat tax, **people could earn more without fear of being pushed into a higher tax bracket**. And the cost savings from a more efficient flat tax system could provide needed tax relief. The flat tax would encourage individuals to earn as much as they please without being penalized.

Comparison of Flat Tax to the Current Income Tax System

CURRENT TAX SYSTEM	*FLAT TAX*
Punishes saving and investing with high tax rates and double taxation.	Ends high tax rates and double taxation of savings and investment to foster economic growth.
Redistributes income	Promotes the creation of income
Encourages investment in unproductive tax shelters.	Ends all tax shelters allowing investment to flow to its most productive uses.
Unfairly levies different taxes on people with like incomes. Numerous special deductions and exemptions are often available to only a select few.	Everyone subject to the same treatment and all taxpayers would face the same low tax rate. Special deductions and loopholes available to select individuals are eliminated.
Encourages spending ones saving by taxing savings and investment twice, sometimes three times.	Ends punitive taxation of savings and investment, leaving individuals free to decide whether to spend, save or invest.
Levies high tax rates that discourage additional work effort and entrepreneurial activity.	One low tax rate allows individuals to earn as much as they will without being punished by the tax system.
The tax code is overly complex and is costly to administer and comply with for both individuals and government.	Ends complexity by eliminating the multitude of deductions, exemptions, and credits.

Principles Of A Good Tax System

- ✓ A good tax system requires that every taxpayer be fully informed on exactly what is being taxed, how they are being taxed, and what their true tax liability is.

- ✓ Taxes should be as visible to the taxpayer as possible. Taxes act as the most important price mechanism for individuals to decide just how much government they are willing to pay for. "Hidden" taxes mask the true cost of government from taxpayers. All citizens should be accurately informed on exactly how their tax dollars are being spent.

- ✓ The tax system should explicitly treat all individuals equally under the law as intended by the Constitution. Deliberate differentiations of tax liabilities on the basis of the sources or uses of income should be avoided.

- ✓ The tax system should provide the same tax treatment for similar economic actions and transactions, rather than taxation based on the attributes of the taxpayer.

- ✓ Multiple layers of taxation should be avoided. Income should be taxed once and only once.

- ✓ The tax system should be as simple as possible. Complexity makes the system expensive, punitive, and results in an efficiency loss to the economy.

- ✓ The tax system should aim for neutrality in economic decision making, favoring neither consumption nor investment.

- ✓ The tax system should not interfere with the free will economic choices and decisions of individuals, households, or businesses.

- ✓ A low tax rate across a broad tax base creates the least incentive distortions in the economy.

- ✓ Changes in the tax law intended to raise revenues should not be retroactive. All taxpayers must have confidence in the law as it exists when planning and entering into transactions.

- ✓ The U.S. tax code must be competitive with other industrialized nations. It should in no way impede the free flow of goods, services, and capital across borders.

- ✓ All government mandated private sector spending and regulations should be properly counted as implicit taxation. Government mandates and regulations reduce the free use of private sector resources.

Flat Tax Q & A

Q & A

Q. Why are so many economists and policy makers calling for a replacement of our income tax system with some type of consumption tax?

A. Consumption-based taxes have grown in popularity because they would largely exempt savings and investment from punitive taxation and this would spur needed capital formation, increased productivity, and improved economic growth. One of the most destructive elements of our current income tax system is that it punishes saving and investing income from these sources are hit with high tax rates and double taxation. This punitive tax treatment makes it far more attractive to spend your income than to save it.

Q. Would a good tax system punish consumption and reward savings and investment?

A. Not at all. People save and invest so they can consume at a later date. The flat tax system would not punish an individual's decision to spend. Rather, the flat tax would end the current double taxation of savings by treating consumption and savings equally under the tax code making the tax system neutral with respect to an individual's decision to save or spend.

Q. Do we need to scrap the income tax system to tax consumption?

A. No. The flat tax would work within the income tax framework. Income can either be spent or saved. Every act of investment in the economy ultimately traces back to an act of savings. The flat tax, by providing an immediate 100 percent tax exclusion for new investment, is precisely a consumption-based tax. It would remove all investment spending from the tax base.

Q. How is double taxation eliminated under a flat tax system?

A. Under the flat tax, earnings on an individual's savings and investment (interest and dividends) would not be taxed, eliminating the double taxation that now occurs when both businesses and individuals pay taxes on the same income. The flat tax system would also eliminate the massive record keeping necessary for businesses, individuals and the government to track and report all interest and dividend payments made each year. The flat tax would levy the same single rate on both business income and individual income from salaries and wages and would scrap the barrage of complex and economically distorting deductions prevalent in the current tax code.

Q. Why is a single tax rate better than a progressive tax with higher rates?

A. Steeply graduated tax rates discourage work by punishing people as they earn more. Graduated rates now allow the government to take a bigger slice of someone's hard work or success. High tax rates exist in the current system largely because a multitude of deductions, exemptions, and tax credits allow certain individuals or businesses to pay little or no taxes, leaving other taxpayers to pick up the tab. All these deductions make incentive-destroying marginal tax rates go up while also fostering complexity, creating inequities, and enhancing Uncle Sam's ability to micro-manage people's behavior. Having only one low tax rate would foster greater work incentives, but plainly, it would be a more equatable tax system.

Q. Aren't there good reasons to allow certain deductions in the tax code?

A. Rarely. Rather than have Uncle Sam collect a big tax bite with high rates and then bribe people by giving them their own money back with a deduction here or tax credit there, the single low-rate flat tax would let people keep more of their own money as they earn it. Business owners, individuals, and families could then decide for themselves the most efficient ways to spend or invest their money without, having to act according to the dictates of Uncle Sam.

Having one tax rate and eliminating the multitude of deductions, would end the special-interest tax break free-for-all that is largely to blame for the complexity, instability, unfairness, and social engineering prevalent in the existing tax code. The flat tax would finally end the use of the tax code by politicians and special interests who attempt to solve every social and economic problem at the expense of taxpayers and economic growth.

Q. Many previous tax reforms promised simplicity that never materialized, would reform be any different this time around?

A. For the more than 80 percent of Americans who get the bulk of their income from salaries and wages, the flat tax system couldn't be simpler. These taxpayers could file a postcard size tax return. Previous tax reform efforts caved in to the pressures of special interests and preserved the numerous costly and complex deductions and exemptions understood and enjoyed by only a few. The flat tax would achieve simplicity because it would tax income only once, at one low rate, and would finally eliminate special interest deductions, exemptions, and credits.

Q. Who will benefit under flat tax system, businesses or individuals?

A. Business and individual income would be taxed at the same tax rate. The flat tax is an integrated system that applies to both businesses and individuals. The business tax is not just replacement for the existing corporate income tax. The flat tax's business tax includes all income from noncorporate businesses, e.g., partnerships and proprietorships. It covers all business income, not just corporate income. And it covers interest income which is currently taxed under the personal income tax system.

First and foremost, you cannot equate the current corporate income tax to the flat tax's business tax. Likewise, you cannot compare the current individual income tax to the tax on wages and salaries. Trying to judge the flat tax on the standards of the current tax system is one of the biggest mistakes committed when analyzing the flat tax.

Simply stated, the business tax is a comprehensive withholding tax on all types of income other than wages, salaries, and pensions. The benefit of this tax is that it taxes income once at its source and only once. Currently there is double taxation on corporate income: once when the company pays income tax and again when individuals are taxed on the company's after-tax payout of interest and dividends. The flat tax would eliminate the punitive double taxation inherent in taxing interest, dividends and capital gains. Ending this punitive double taxation will spur savings and investment vital to economic growth and an improved standard of living.

Q. Is it fair to tax corporations and businesses at the same tax rate as individuals under a flat tax?

A. The current corporate income tax is borne by individuals who are the owners of corporations (shareholders), workers in the corporation, or consumers of corporate products.

Remember that corporate structures do not pay taxes— people pay taxes.

Levying the same tax rate on businesses and individuals guarantees that all income is taxed and taxed fairly. The flat tax's business tax is designed to collect the tax that owners of a business owe on the income produced by the business. Clearly, business income is taxed at its source.

Any tax initially imposed on a corporation or business is ultimately borne by consumers, workers, owners and investors. Corporate taxes can only result in reduced returns to shareholders, lower wages for employees, or higher prices for consumers. Unfortunately, there is no clear cut way to know the exact amount of corporate taxes a particular individual pays. In fact, the Joint Committee on Taxation does not attempt to show the individual's share of corporate taxes, thereby ignoring the burdens on individuals imposed by a tax that raised $150 billion last year. This results in inaccurate and misleading tax burden distribution tables so often quoted by policy makers.

Q. How is all income taxed under the flat tax system?

A. Under the flat tax, each firm pays a tax on the total amount of income generated by the firm less that firm's investment in plant and equipment and income paid to their workers. The workers then pay the tax on what they earn, making the flat tax an airtight integrated tax system.

The effects of a Flat Tax on Business:

Ends punitive double taxation of business income and fosters increased savings and investment needed for business development and expansion.

Ends individual capital gains and dividends taxation which eliminates double taxation of business income and will spur increased corporate investment.

Allows a 100% first-year expensing of new business investment (plant, equipment, land). This eliminates one of the biggest accounting nightmares-- numerous depreciation schedules that need to be kept for 10, 20, and even up to 40 years for each investment or purchase. Immediate expensing would also spur new investment and increased productivity by quickly freeing up capital needed in fast growing businesses.

Mitigates accounting nightmare of keeping track of all interest and dividends paid out (1099 forms), this income would be taxed at the business level. Individuals would not be taxed again on interest and dividends.

A single, low flat tax rate would eliminate the disincentives caused by high marginal tax rates now faced by growing businesses.

Reduces complexity in the taxation of multinational corporations. The flat tax only applies to domestic operations of all businesses, whether they are domestic, foreign, or mixed ownership. Only the revenue from sales of a product within the U.S,. plus the value of products at export would be reported on the business tax form.

Q. Will the flat tax bring in the same amount of revenue as the current income tax system -- in other words would it be "revenue neutral?"

A. Revenue neutrality is not a problem! Any flat tax system can be designed to meet the revenue neutrality goal simply by setting the appropriate tax rate and deductions that are allowed. "Revenue neutrality" can easily be accomplished, but it is not the sole focus of the tax reform debate and should not prevent us from improving our tax system to spur economic growth.

Q. If the tax system is radically reformed and we preserve revenue neutrality, who will be the "winners" and "losers?"

A. Everyone will be a winner under a more simple and efficient tax system that removes all the current economic distortions that now hamper our nation's needed investment, productivity, and wage and job growth. The flat tax would better enable the economy to reach its full potential and afford all Americans a better standard of living.

The static income distribution models currently used by the Congressional Budget Office (CBO), Treasury and the Joint Committee on Taxation (JCT) cannot show the benefits from this type tax reform. Unfortunately, the defenders of the status quo will attempt to use fraudulent distribution numbers to

The static income distribution models currently used by the Congressional Budget Office (CBO), Treasury and the Joint Committee on Taxation (JCT) cannot show the benefits from this type of tax reform.

discredit the flat tax. These models have been proven wrong time after time. If we see beyond the current static analysis and reform our tax system that we know is unfair and restricts economic growth, everyone will be better off.

Under the flat tax, those who work hard will do better, those who have concentrated on avoiding taxes with unproductive tax shelters will likely do worse in the short run.

Q. What guarantee is there that the flat tax would improve economic growth?

A. The potential economic benefit from a low rate flat tax isn't just wishful thinking. Lowering high marginal tax rates worked for Presidents Kennedy and Reagan and resulted in robust economic growth. This growth meant higher wages, more jobs and improved living standards across the income spectrum, as well as increased revenues for the Treasury. We don't need income distribution models to predict this -- it a historical fact.

Q. What deductions would be eliminated under a flat tax?

A. Only personal deductions for individuals, families and dependents would be allowed. Beyond that, the low single tax rate would offset the loss of deductions. People would be better off under a low single tax rate that lets them keep their own money as they earn it.

Today's system, with its high tax rates that combine with double and even triple taxation, can take more than half of someone's income. With such confiscatory rates, it's no wonder people and special-interests seek and demand special deductions and loopholes in an attempt to lower their tax burden. But under a low flat tax rate, people will keep 83, 84, or 85 cents of every dollar they earn, instead of only 50 cents, they want need special deductions.

Most people realize that deductions and loopholes are what makes the tax system complex and tremendously unfair, allowing only a select few to take full advantage.

Most people realize that deductions and loopholes are what makes the tax system complex and tremendously unfair, allowing only a select few to take full advantage. Is it fair for a multimillionaire to donate a million-dollar art work and virtually wipe out his tax liability? Is it wise to have people invested in unproductive tax shelters only to lower their high tax burden?

Q. What about the mortgage interest deduction, don't we want to encourage home ownership?

A. The removal of the mortgage interest deduction would be offset by a lower tax rate and lower interest rates under the flat tax system. First: The demand for housing is driven largely by the amount of peoples' after-tax income and the growth of the economy. A low rate flat tax that boosts incomes and lowers taxes would offset the need for the mortgage interest deduction. Second: Interest rates would fall under a flat tax system, lowering the cost of home ownership. Since individual interest income is not taxed under the flat tax, interest rates would drop to reflect the tax-free status of interest (similar to current municipal bonds that pay a much lower interest rate because of their tax-free treatment.)

A flat tax system that improves economic growth, and job opportunities, raises incomes, and lowers interest rates could only boost the demand for housing..

Q. If the flat tax doesn't tax interest, dividends and capital gains income, want this be a giveaway to the "rich"?

A. Not at all. The flat tax would finally end the current "rich" vs. "poor" tax warfare that has hindered everyone. The "soak-the-rich" talk may score some political points, but it's bad economics.

The flat tax will not be a "giveaway" to the rich. Someone with one-hundred times the taxable income would pay one hundred times more in taxes. Ending the tax on capital gains, dividends, and interest income would simply remove the punitive and destructive double taxation that <u>everyone</u> now faces when they decide to save and invest. Interest, dividends, and capital gains simply represent returns on income -- income that has already been taxed. There are no "giveaways". All income from businesses and individuals would be taxed under the same flat tax rate, but now it will be taxed once and only once. Income earned by shareholders cannot escape taxation or be sheltered because it will be taxed at the business level. Interest and dividends paid out would not be deductible under the flat tax's business tax. In other words, no deductions would be allowed for these payments by those making them. This puts the equivalent of a withholding tax on interest, dividends and capital gains at the business level. Therefore, the interest dividends and capital gains received by the "rich" and everyone else have already been taxed at the business level and cannot be sheltered.

Q. Would a flat tax that forces everyone to pay the same tax rate, be "fair" given that today's system makes upper income individuals pay a higher or "progressive" tax rate?

A. What could be more fair than having two people with the same income pay the same tax. Everyone knows we don't have fairness today when some people can "game" the tax system to lower their tax burden at the expense of others.

We have learned over time that higher tax rates do not necessarily result in higher tax payments. Higher tax rates more often have resulted in lowering federal revenues because people work less and invest in unproductive tax shelters to avoid the higher tax rate.

Graduated tax rates in the current system are in no way synonymous with "fairness" when loopholes and special-interest deductions and exemptions abound. Under the flat tax, eliminating special interest deductions and applying only one tax rate would finally allow all taxpayers to know with certainty what their tax liability is.

Subjecting everyone to the same low single tax rate on the fruits of their efforts is fundamentally fair. Can we say the tax system was more fairer when the top rate was 28%, 50%, 70%, or even 94%? Even with this wide range of tax rates, the federal government collected approximately 19 percent of GDP in income tax revenues.

A flat tax system with a personal exemption and a deduction for dependents would protect low-income individuals and families.

Q. How would the flat tax effect Social Security taxes?

A. The primary focus of the flat tax is to reform the federal income tax system. The flat tax would not change the current Social Security tax and benefit system. The Social Security system deserves separate attention.

How a Flat Tax Benefits Individuals

The decision to save or invest would not be punished with double taxation. After income is taxed once at a low, flat rate, if it is saved or invested, the returns (interest and dividends) will not be taxed again as under the current system.

Ends taxation of capital gains. An individual's income investment in a home or small business would be free from the punitive double taxation of capital gains when sold.

Ends estate and gift taxes that represent double taxation and transfer income from families to government.

Dramatically reduces the time, effort, and cost of complying with the tax code. Taxes can be filed on a form the size of a post card.

Helps all consumers by reducing interest rates. For example, the interest on home mortgages, credit cards, and auto loans would be reduced. Since interest income is no longer taxable under the flat tax, interest rates would drop to reflect the tax-free status of interest (similar to today's municipal bonds that have a lower interest rate because of their tax-free treatment.)

Individuals and families would not be punished and discouraged by higher tax rates if they work longer or harder to improve their standard of living. With only one low tax rate, Uncle Sam will not take an increasingly larger chunk of someone's income by putting them into a higher tax bracket. One tax rate means a spouse's income could no longer push a family into a higher tax bracket.

Increases individual freedom of choice and civil liberties. One low tax rate would allow people to keep more of their money as they earn it and would end government's current micro-management of people's behavior through the tax code. A simple flat tax would reduce the IRS's infringements on privacy.

Q. What about the popular deduction for state and local taxes. If this deduction is eliminated, would people in high tax states be forced to pay more? Is this "fair"?

A. Only deductions for individuals, families and dependents are allowed. Beyond that, the tremendous benefit of a low single tax rate would offset anyone's need to be dependent on Uncle Sam for deductions. People would be better off under a low single tax rate that lets them keep their own money as they earn it.

The federal tax code should not subsidize and encourage states and localities that choose to levy high taxes at the expense of residents of low-tax states. The cost of a particular state or local government's spending should not be shifted to others through the federal tax code. The issue of high state and local tax burdens should be taken up with state and local officials who levy them. The burden should not be paid by others outside the state.

As we have witnessed, today's deductions can be gone tomorrow. There would never be a guarantee that Uncle Sam will preserve any deduction over time. Remember, for example, state sales taxes that were deductible are no longer allowed. We would be much better off with a single low rate under the flat tax than to be at the mercy of Uncle Sam's whims.

Q. How would state tax systems that largely piggyback on the federal income tax system be affected?

A. States can easily adapt their systems to the flat tax reform (as they did after the 1986 Tax Reform Act that lowered tax rates and broadened the tax base.)

Q. Why would the flat tax system tax people's health benefits and other fringe benefits that are now provided tax-free to individuals and deducted from the employer's taxes? Would employers drop their health insurance plans and other tax free benefits?

A. Employers could choose to pay their workers increased cash wages (which are deductible) rather than compensation in the form of fringe benefits. This has the added value of allowing the employee more choice and control over benefits. Employers would not be prevented from providing benefits like health insurance.

Q. If we give up the bulk of our deductions in exchange for the low single flat tax rate, what's to prevent Congress from jacking up the rate later?

A. As we know all too well, Congress always has the ability to raise taxes. But under a flat tax, a tax rate increase would have an impact on all taxpayers. This would foster greater opposition and Congress would know that each and every constituent will be hit with a higher tax burden if they voted to raise the rate. Today, lawmakers can play the game of taxing one income group at a time, taking the path of least resistance. The flat tax would terminate the "soak-the-rich" bait and switch tax hikes that end up socking everyone.

The flat tax would allow only one tax rate for businesses and individuals. This would also put an end to false claims that taxes were raised only on corporations when we know that all taxes are paid by individuals anyway.

A flat tax reform could also include a "super-majority" provision for tax increases. It would require a three-fifths vote of Congress to raise the tax rate. Some have suggested a Constitutional "super-majority" amendment to curb lawmakers' perpetual urge to raise taxes.

CONCLUSION

Since the passage of the 16th Amendment in 1913 (allowing an income tax), the income tax system has been incrementally reformed and tinkered with for eight decades. Tinkering is not the answer. With few exceptions, this has compounded the complexity and distortion prevalent in the current tax system. Therefore, the time is right for a flat tax system that is simple and equitable.

Levying a flat tax is not a radical idea. In fact, except for the income tax, flat taxes abound -- the Social Security tax, Medicare tax, sales taxes, property taxes, government licenses and user fees -- all use a single fixed rate regardless of income.

A flat tax system would finally end the inherent unfairness, complexity, government micro-management and economic damage caused by the current income tax system-- spring economic growth and opportunity while providing all Americans a higher standard of living.

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